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ACCOUNTING REPORTS FOR MANAGEMENT INVESTMENT COMPANIES

Frank P. Smith

In the past 15 years American investment trusts and investment companies have developed from a little-known type of financial institution to the stature of an established industry.[1] In this relatively short period the new industry has been faced with the varied problems of developing investment, trading and dividend policies, reporting techniques, and accounting principles and procedures. It is not surprising that the same rate of progress was not maintained in all fields but it is unfortunate that one of the early lags appeared in the field of reporting techniques.

In their early years American investment companies were influenced to some extent by the experiences of British investment trusts. British companies had been operating for approximately fifty years before American investment companies became important, and had apparently adapted British accounting procedures to their needs.[2] Howefer, this influence was short-lived. American companies were evolving under different tax laws and were pursuing more aggressive trading and dividend policies than were the well-established British companies. In addition, American companies were faced early in the development of the industry with the accounting and reporting problems arising from (1) a very rapid increase in size, (2) rapidly increasing stock prices, and (3) subsequent drastic breaks in stock prices. Consequently, American investment companies shouldered, under difficult circumstances, the task of adapting or developing accounting principles and reporting methods to fit the needs of a new industry.

The rapid increase in importance of American investment companies can be indicated by tracing the number of companies in existence and the assets of these companies. Only a few investment companies were developed prior to 1924; by the end of 1927 the number had increased to 120 with assets of 1.8 billions of dollars; and by the end of 1929, to 279 with assets of 6.3 billions of dollars. The number of companies increased after this date but their total assets fluctuated below the 1929 figure. At the end of 1936 there were 345 investment companies with assets of 4.3 billions of dollars.[3] The groundwork for investment company accounting and reporting was established in these early years of rapid expansion.

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[1] Senate Report No. 1775, 76th Cong. 3d sess., p. 3.

[2] British management and unit type trusts are discussed in "Investment Trusts in Great Britain," report of the Securities and Exchange Commission, (SEC) 1939. For a brief treatment of the historical development of British trusts see Theodore J. Grayson, *Investment Trusts*, John Wiley & Sons, 1928, chp. II; William H. Steiner, *Investment Trusts*, Adelphi, 1929, chp. II; Marshall D. Ketchum, *The Fixed Investment Trust*, The University of Chicago, 1937, chp. II.

[3] These totals include investment-holding companies. SEC "Investment Trusts and Investment Companies," 1939, Pt. II, Table 17, pp. 112–114. The complete report will be referred to as "SEC Report."

The history of this industry can be divided roughly into three periods, each of approximately 5 years in length. The first period includes the boom years of the late Twenties when investment companies were springing up overnight and were primarily concerned with the sale of securities. During these years the buying public demonstrated a preference for management companies and most of the companies formed were of the closed-end type.[4]

The second period includes the severe depression years of the early Thirties. During these years open-end management companies attained some degree of popularity but a large number of the companies formed were of the fixed or semi-fixed type.[5] In retrospect, investment companies appear to have been devoting more attention in this period to presenting effective sales literature, and to minimizing the effects of depressed security prices, than to developing sound accounting principles and informative financial statements.

The third period includes the years following the depths of the depression. The numbers of closed-end management, and fixed and semi-fixed companies decreased, but the number of open-end management companies increased somewhat and the number of companies selling instalment investment plans increased rapidly. It was in this period, with a new type of investment company becoming popular, and the buying public indicating a renewed confidence in open-end management companies, that much of the improvement in investment company accounting practices and reports occurred.

Much of the improvement in reports observed in the third period of investment company history can be attributed directly to the influence of the Securities Act on companies selling new securities, and the influence of the Securities Exchange Act on issuers of listed securities.[6] Many of the larger investment companies are included in these two groups but there are also many others which have not come directly under the influence of the accounting requirements established by the Securities and Exchange Commission (SEC).[7] For this latter group of companies, the requirements of the SEC are only of indirect importance and other factors may have been more influential in clearing the way for improvements in accounting procedures and reports. Perhaps of some importance is the fact that the expansion period for many of these companies had ended and the managements were able to turn attention from sales promotion and organization of new companies and units to such matters

[4] "So rapid was their organization (closed-end companies) during this period, that by 1929 they were being created at the rate of almost one a day." Senate Report No. 1775, *op. cit.*, p. 3. The principal difference between closed-end and open-end companies is that the latter companies offer to security holders the privilege of redemption at approximate asset values.

[5] "In the fixed or unit investment trusts, management discretion is completely or almost completely eliminated The investor is sold an undivided interest in a specified package or unit of securities, which are deposited with a trustee. The underlying securities cannot be changed, or can be eliminated only upon the happening of certain specified contingencies, such as the passing of a dividend on any security in the package for a prescribed period of time, or the reduction in the investment rating of the security by a prescribed statistical service." Senate Report No. 1775, *op. cit.*, p. 3. See also Marshall D. Ketchum's monograph, *The Fixed Investment Trust*, 1937, and the detailed report of the SEC, "Fixed and Semifixed Investment Trusts," 1940. In the later semifixed trusts the management is permitted more discretion in the selection of substitute investments than is suggested by the above statement.

[6] See testimony of William W. Werntz, Hearings before a Subcommittee of the Committee on Banking and Currency, United States Senate, 76th Cong., 3d sess., on S. 3580, "Investment Trusts and Investment Companies," Pt. II, p. 910.

[7] At the end of 1936 there were 206 issues of investment companies admitted to listed or unlisted trading privileges on stock exchanges. Of this total there were 112 issues of closed-end management companies and 75 issues of management investment-holding companies. SEC Report, *op. cit.*, Pt. II, Table 86, p. 293. In the period July 7, 1933–December 31, 1939, investment companies registered approximately $2,161,000,000 of securities under the Securities Act of 1933. This may be compared with total registrations of common stock of approximately $4,000,000,000. See testimony of Baldwin B. Bane, Senate Hearings, *op. cit.*, pt. I, p. 135.

as accounting policy and the adequacy of financial statements. Another factor which undoubtedly had some influence was the demand on the part of the investing public for improved financial statements. This demand may have been stimulated by the disclosures before the SEC in connection with its study of investment companies.

REPORT OF THE SECURITIES AND EXCHANGE COMMISSION

The study of investment companies conducted by the SEC was authorized by Section 30 of the Public Utility Holding Company Act of 1935. This study was to be completed and the results and recommendations reported to Congress by January 4, 1937. However, the complexities of the problems encountered, and the large number of companies in the field, were such that much of the report was not made public until 1940. The report thus summarizes the results of a four-year study of the more important aspects of investment company activity, including investment policies, capital structures, transactions with stock and certificate holders, dividend policies, and accounting practices and policies. The study relates principally to the years 1927–35, and includes detailed criticism of such accounting matters as the reporting of profits on transactions in securities of affiliated companies, the reporting of security profits without disclosing largelosses charged to reserves or to capital surplus, the payments of dividends from "income" which were in reality a return of capital, the charging of expenses to surplus without disclosure, the reporting of portfolio securities at cost without indicating existing depreciation of market values below cost, and the transfer of reserves to profit and loss without adequate disclosure. In some instances the accounting procedures are criticized, but in many cases the principal criticism relates to the inherent unsoundness of the transactions themselves or to the manner in which the transactions in question were reported or concealed in reports to stockholders. These detailed criticisms emphasize the fact that few accounting principles and practices were developed, and recognized principles were not generally followed by investment companies in the years 1927–35.[8] The objection is not that the different types of companies followed different accounting practices, but that different companies of the same type followed policies which were frequently diametrically opposed.[9] In fact, there were numerous instances of investment companies which seemingly adopted those practices and procedures which would make the best possible showing in their reports to stockholders. In such cases the reporting and accounting "policies" were closely allied with sales literature. However, not all investment companies adopted such methods; some companies prepared their reports on reasonable bases and attempted to establish sound accounting principles for the industry.

CLASSIFICATION OF INVESTMENT COMPANIES

The accounting and reporting problems of investment companies vary to some extent between companies of the different types. The following discussions will be restricted to a few of the major reporting problems of management companies, and will be stated in terms of open-end and closed-end diversified companies, and closed-end non-diversified companies.[10]

[8] Much was written, in these years, of investment company operations and policies but there was little consideration of related accounting matters. Perhaps the most thorough treatment is that of Leland Rex Robinson, *Investment Trust Organization and Management*, rev. ed., Ronald, 1929, chps. 15–17. See also Herman E. Schreiber, "The Accounts of an Investment Trust," *Journal of Accountancy*, Vol. 47 (1929), and John S. McMartin, "Reporting Investment Trust Income," *Harvard Business Review*, IX (1930–31).

[9] Werntz, *op. cit.*, pt. II, p. 910.

[10] There are three other principal groups, periodic investment plans, face amount certificate companies, and fixed and semi-fixed companies. The first type sells in-

Companies of the management type are the most important single group of investment companies.[11] The principal characteristic of companies in this group is that the managements are relatively free of restriction regarding employment of the companies' fund. However, the individual companies may operate very differently under these broad powers; companies are classified according to the type of restrictions placed upon management rather than according to the type of operations conducted under these restrictions.

Diversified companies are alike in that they invest most of their funds in readily marketable securities. However, there are important differences between the individual companies in this group as to the amount of their trading activity. The maintenance of a diversified list operates as a check on the size of short-term market positions but of course does not restrict changes in holdings, provided that the required degree of diversification is not impaired. Diversified companies as a group are interested in appreciation although individual companies emphasize this feature in varying degrees. In general, diversified companies probably place less weight on investing for appreciation than do the non-diversified companies which are permitted by their charters or articles to invest larger amounts in single issues.

Non-diversified companies are even less homogeneous than are the companies in the diversified group. Non-diversified companies are alike in that they are permitted by their charters or articles to concentrate holdings in a small number of companies. Their freedom from restriction in this respect also means that a correspondingly wider range of activity is permitted in other fields such as short-term trading. However, there are also many variations in other respects between the individual companies. Some non-diversified companies concentrate their investments in a single industry, some trade actively, some invest in special situations which offer unusual opportunities of appreciation.

INVESTMENT COMPANY REPORTS

Spokesmen for the industry have emphasized that the findings of the SEC refer to the 1927–35 period, that years prior to 1932 were "the promotional and inflationary stage," and are not representative of the industry today. These spokesmen argued that investment companies have "cleaned house" of unsound accounting practices, and maintained that their reports to security holders are the "clearest and most understandable of any form of

vestment plan certificates which are usually payable over a period of years. The payments of certificate-holders, net of expenses and fees, are invested in specified "underlying" securities which are, in most cases, the shares of other investment companies. At the end of 1936 there were 46 companies of this type but their combined assets amounted to only one per cent of the assets of all investment companies, excluding investment holding-companies and unclassified companies. There were 5 companies selling face amount instalment certificates at the end of 1936, and these companies owned approximately six per cent of the assets of investment companies. The largest of these was reported in 1940 as having gross assets of slightly over $160,000,000. Testimony of E. E. Crab, Senate Hearings, *op. cit.*, pt. IV, p. 1128. The companies of this type sell instalment certificates which are, in effect, obligations of the issuer to pay a stated sum at a definite date.

There were 61 fixed and semi-fixed companies at the end of 1936, owning approximately eight per cent of investment-company assets. See note 5 regarding the activities of fixed or unit type companies. The semi-fixed company is usually of the fund rather than the unit type, the portfolio is continuously supervised, and investments are changed for long-term investment reasons. The investment policy of a semi-fixed trust may, therefore, be similar in nature to the policy of the ideal management company. See Ketchum, *op. cit.*, p. 44. The discussions in the present study are directed specifically to the reporting problems of management companies, but are, in many respects, also applicable to semi-fixed companies.

For numbers and values of assets of the different types of investment companies, see SEC Report, *op. cit.*, pt. II, Table 17, pp. 112–114.

[11] At the end of 1936 there were 152 management companies owning 84% of the assets of investment companies, exclusive of investment holding-companies and unclassified companies. Management companies were further classified by the SEC as "closed-end" companies, 113, and "open-end" companies, 39. SEC Report, *op. cit.*, pt. II, Table 17, pp. 112–114.

business report."[12] Some investment companies are presenting to security holders annual and quarterly reports which rank very high in comparison with the reports of other industries. However, the claim of wholesale improvements in investment company reports may be questioned.[13]

There are two sources of information regarding the type of reports which investment companies are furnishing at the present time, namely, reports to the SEC, and reports to stockholders. Reports to the SEC are furnished by companies registering new securities under the Securities Act, and by companies with issues listed on stock exchanges. Reports furnished in compliance with the provisions of either the Securities Act or the Exchange Act are made in accordance with the forms adopted by the SEC.[14] Consequently, the information included in such reports must be considered in the light of the requirements of the appropriate forms on which the various companies file, and does not indicate the extent to which investment companies have voluntarily improved their accounting and reporting methods. Moreover, despite the influence of these forms, there are important and, at times, irreconcilable differences in the reports of registered companies of a similar type. This situation is explained by the fact that both the Securities Act and the Exchange Act are disclosure statutes and in most cases no one procedure is made mandatory.[15]

[12] See testimony of Cyril J. C. Quinn, Senate Hearings, *op. cit.*, pt. II, pp. 388–390.

[13] The Senate Committee found that "The accounting practices and financial reports to stockholders of management investment companies frequently are deficient and inadequate in many respects and ofttimes are misleading." Senate Report No. 1775, *op. cit.*, p. 8.

[14] The SEC has developed Form C-1 (Securities Act) for unincorporated companies of the fixed or restricted management type. Other investment companies registering securities under this act use Forms A-1 or A-2. Management companies registering in compliance with the provisions of the Exchange Act use Form 15 (incorporated companies) and Form 17 (unincorporated companies).

[15] Werntz, *op. cit.*, pt. II, p. 910.

The best measure of the extent of voluntary improvement in investment company reports is to be found in the annual reports to stockholders. Current reports reflect a marked improvement over earlier statements and such improvement can be attributed largely to voluntary action by the investment companies.[16] However, despite the importance of these improvements, an examination of a number of 1939 reports suggests that the accounting and reporting practices of investment companies have not progressed to the extent claimed by spokesmen for the industry.

VARIATIONS IN ANNUAL REPORTS

In order to illustrate the variations in reporting practice among investment companies, the reports to stockholders of 22 management companies, for the year 1939, have been classified according to the accounting and reporting treatment of a number of items.[17] The number of companies studied is small in relation to the total number of management companies and important differences are recognized between some of these companies, particularly between open-end and closed-end companies. The list is probably biased in favor of the more progressive companies and is not intended to serve as a statistical sample. The variations are merely present-

[16] Some direct influence is exerted on listed companies by the proxy rules adopted by the SEC (see Regulation X-14, adopted under the Exchange Act), and by stock exchange regulations.

[17] The following companies are included: Adams Express Company, American Cities Power & Light Corporation, American General Corporation, American International Corporation, Blue Ridge Corporation, Broad Street Investing Corporation, Bullock Fund, Ltd., Capital Administration Company, Ltd., Carriers & General Corporation, Dividend Shares Inc., General Shareholdings Corporation, Incorporated Investors, Lehman Corporation, Liberty Share Corporation, National Bond & Share Corporation, Nation-Wide Securities Company, Prudential Investors, Inc., Selected Industries Incorporated, Spencer Trask Fund, Inc., Tri-Continental Corporation, Utility Equities Corporation, Utility & Industrial Corporation. The combined assets of these companies, as of the fiscal year ending in 1939, totaled approximately $500,000,000.

ed to suggest that all members of the industry have not been willing to adopt substantially similar reporting methods.

Items and Procedures	*No. of Companies*
Balance Sheet Statement of Portfolio Securities:	
At cost, with market or unrealized appreciation or depreciation stated	14
At market, with cost or book value shown parenthetically, by note, or by reserve	4
At cost or less, with unrealized depreciation shown in note	1
At market of some prior date, plus subsequent purchases at cost, with market shown parenthetically	3
Treatment of Security Profits and Losses:	
Included in income statement	3
Included in earned surplus or undistributed profits	11
Included in paid-in or capital surplus	4
Included in special surplus account	3
Other*	1
* Losses on securities acquired prior to—charged to reserve; profits on securities acquired subsequent to—included in combined income and surplus statement.	
Methods of Computing Security Profits and Losses:	
Average cost	16
First-in, first-out	3
First-in, first-out, or specific certificate	1
No basis given	2
Information furnished regarding Portfolio Securities:	
Number of shares only, by issue	3
Number of shares and per cent of assets, by issue	2
Number of shares and market value, by issue	8
Number of shares, market value, and per cent of assets, by issue	9
Earned Surplus dated from—subsequent to organization:	
1931—1 company	
1932—2 companies	
1933—2 companies	
1936—5 companies	
1937—1 company	11
Net Asset Value per share:	

Items and Procedures	*No. of Companies*
Stated*	19
Not stated	3
* 2 of these companies were silent on the point that junior stock had no asset value.	

INTERPRETATION OF REPORTS

The lack of agreement as to appropriate reporting methods, which is indicated by the data above, emphasizes the difficulty which the investor or prospective investor faces when he attempts to determine the investment value of a particular company's securities. An investor who buys securities issued by an investment company is seldom purchasing the securities of a specific company because these and these only meet the precise conditions he has laid down for himself. The informed investor buys because this particular security appears to be better than those issued by other companies of a similar type. An investor can compare the results of different companies only by means of the information disclosed in financial statements, and his investigation is sadly hampered if he finds that different companies of the same type have followed different accounting and reporting practices. This is the principal argument for uniform reporting practices within an industry and it is particularly pertinent to investment companies.[18] It is unimportant from this point

[18] "Uniformity of disclosure is particularly important to stockholders and investors with respect to investment trusts. Essentially, the investment trust is selling an investment service which usually is coupled with continued managerial discretion in the type of investments to be made. While this is the common feature of all investment trusts, it does not mean that there are not different types of trusts and that as between these different types of trusts there should not be differences consistent with their inherent purposes and expressed appropriately in their accounting and reporting. Nevertheless, if two investment trusts fall within the same general group, it is extremely important, in my opinion, that their financial statements and the principles upon which those financial statements are based should be as nearly uniform as is possible, so that stockholders and investors may readily compare the performance of the two trusts." Werntz, *op. cit.*, pt. II, pp. 910–911.

of view whether greater comparability of reports is accomplished by legislation, trade association activities, voluntary agreements, stock exchange requirements, or by other devices. The statements of different investment companies should be comparable to be of service to investors.

REPORTING PROBLEMS

Different types of reporting problems are, of course, encountered by the various types of management companies. For example, open-end companies obviously have some problems which are different from closed-end companies, and there are differences between diversified and non-diversified companies. However, there are some reporting problems which are more or less common to all these groups and, while the solutions may vary somewhat according to the type of company, the same basic problems are involved. Four of these problems are of particular importance.

1. Reporting portfolio securities values.
2. Reporting security profits and losses.
3. Reporting redemptions of securities.
4. Reporting dividend distributions, and determining income economically available for distribution.

The following discussions of the four general problems enumerated are not based on legal considerations. Investment companies may do many things which are legally correct but are economically unsound.[19] The basic fault may rest with the incorporation statute, but in many cases investment companies themselves have included provisions in their Articles which permit the reporting of items on bases which are not sound from an economic point of view. The fact that such policies are legally permissible does not bar the criticism of them for economic reasons.[20]

REPORTING PORTFOLIO SECURITIES VALUES

The assets of an investment company obviously consist largely of securities. The proportions of assets which are held in the form of securities, cash, or other investments, may vary from year to year with an individual company and between different companies for the same year. The proportions of securities which are marketable and non-marketable may vary in a similar manner, and the make-up of the portfolio may change rapidly or slowly, depending on the trading policy of the company and the type of market movements developing in different periods. The investor is interested in these operations, both from the standpoint of his own company and for comparison with other companies of a similar type. The investor is also interested in financial statements which present a clear picture of the results of operations and the position of his company at the balance sheet date, and which can be compared with earlier statements of his company and with statements of other companies of similar type. From the standpoint of the balance sheet, the principal problem in this connection is the presentation of portfolio securities values.

[19] "There are times when satisfactory accounting . . . will be handicapped in some degree by conflicting provisions of corporate laws. This possibility need not, however, avoid the establishment of principles of good accounting and finance. Many things are lawful, but this does not make them logical. The accountant must proceed in a rational manner and then comply in each jurisdiction to the legal requirements established by the legislatures and courts." C. Rufus Rorem, "Accounting Theory: A Critique of the Tentative Statement of Accounting Principles," ACCOUNTING REVIEW, June, 1937 p. 138. See also Samuel J. Broad, "Some Comments on Surplus Account," *Journal of Accountancy*, October, 1938, p. 217.

[20] "Whenever debtors and creditors enter into contractual relationships, financial condition becomes an important consideration. This is very largely a legal matter. But a business enterprise is more basically an economic unit than it is a legal institution; finance and debt are secondary to the primary economic activity of producing an output which will be acceptable to customers. Therefore it is possible to say that economic condition, not financial condition, is of first importance in a business enterprise." A. C. Littleton, "Concepts of Income Underlying Accounting," ACCOUNTING REVIEW, March, 1937, p. 16.

Investment companies may have been influenced in their selection of balance sheet presentations by the reporting practices of companies in other industries. The conventional accounting practice is to record assets acquired at cost, and to compute profit and loss on disposal of assets on a cost basis. There can be little question of the propriety of this method whether applied to a commercial, industrial, or investment company. Commercial and industrial companies have also extended to their balance sheet presentation the convention of stating assets at cost, and while this method is, in general, entirely sound for such companies, it does not necessarily follow that the same convention is logical for an investment company. However, investment companies have, in general, followed the precedent of commercial and industrial companies and have prepared their balance sheets on a cost basis with aggregates based on market quotations shown in a note.

The importance of a comparison of portfolio values stated at market, as contrasted with a comparison based on cost, emphasizes an important practical difference between investment companies, and industrial and commercial companies. In the usual situation the industrial or commercial company does not have the choice of using either current market values or cost values. Instead, the choice is between stating assets at cost, or at some arbitrary and less significant figure. In contrast, investment companies, particularly diversified companies, do have the practical alternative of stating at least the greater part of their assets at cost, or at market. Their portfolio securities may consist wholly or partly of stocks and bonds enjoying a ready market and the current value of such marketable securities can be determined as of the balance sheet date without particular difficulty. However, a non-diversified company may be unable in many instances to state its assets on the basis of market quotations. Trading companies buy marketable securities and can determine the quoted value of at least the greater part of their assets, but companies buying into special situations may have large amounts invested in securities for which there is no ready market. In other instances a market may exist but may be based on such a small turn-over as to be of little value. These latter securities, and similar investments of diversified companies, would of course be shown at cost or at cost less investment reserves, whenever an authentic market does not exist.

Investment companies also differ from companies in other fields in that there is no question of amortizing periodically the appropriate portion of expired service lives of assets. Depreciation, to investment companies, relates with minor exceptions to a comparison of cost or other book value and present market quotations. There is no question of spreading the cost of the securities over an estimated service life.[21] Furthermore, a portfolio security is not purchased for conversion into salable products or services; it is purchased as an investment, even though possibly a temporary investment, rather than as a merchandising operation.

At the present time more investment companies prepare their balance sheets on a cost basis than on a market value basis. The essential matter to an investor is that both cost and market values be shown, since he is thereby enabled to make his own adjustment if he prefers the alternate method.[22] However, for balance sheet pur-

[21] With the possible exception of securities on which periodic liquidating dividends are being paid.

[22] Securities are required to be shown at market, with cost indicated, in balance sheets filed with the SEC on Form C-1 (Securities Act). However, Forms 15 and 17 (Exchange Act) merely require that both cost and market be shown (with a note to surplus for unrealized depreciation) and do not specify that market shall be extended in the balance sheet. The New York Stock Exchange recommends that securities be carried at cost and that unrealized appreciation or depreciation,

poses, the market value of portfolio securities appears to be a more important figure than the cost of securities.[23]

REPORTING SECURITY PROFITS AND LOSSES

One of the problems involved in reporting security profits and losses is the location of this item in the financial statements. The importance of security profits and losses will vary according to the amount of trading, and according to the width and rapidity of price swings in the market. Even for the most skillfully managed investment company, the amounts of periodic security profits and losses will vary widely between periods and, in general will show a high degree of correlation with price movements, profits appearing on upward movements, and losses appearing in periods of declining stock prices. Consequently, security profits and losses are irregular and non-recurring by comparison with the more stable incomes from interest and dividends. This distinction should be embodied in the financial statements by reflecting security profits and losses in a separate section of the income account, or by carrying such profits and losses directly to a separate surplus account. Both of these methods are used but the results of operations of a management company are more clearly shown by reflecting security profits and losses, properly designated, in the income statement.[24] An additional refinement which would aid the reader in interpreting the balance sheet would be to isolate net undistributed security profits, or deficits from security transactions, as a separate part of earned surplus, with dividends charged against such income clearly indicated.[25] However, regardless of the method used the investor is entitled to an adequate statement of (1) undistributed income from interest, dividends, and commissions, (2) undistributed profits, or deficits, from security transactions, and (3) the source of dividends paid in excess of

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and change during the period, be shown in footnotes. See "Statement on Investment Trusts of the Management Type," 1931.

[23] A similar view is expressed by George E. Niven, "Investment Trusts", *The New York Certified Public Accountant*, February, 1940, p. 286. For an early discussion of this point see Herman E. Schreiber, *op. cit.*, pp. 253–255.

Those who favor stating security values of investment companies at cost, with market values shown parenthetically, argue that market values are transitory, and the reflection of inflated values in the balance sheet may mislead investors. A similar objection can be advanced against a balance sheet based on cost values when unrealized depreciation exists, but the supporters of this method argue that unrealized depreciation can be clearly set forth by the creation of reserves. This line of argument apparently denies that unrealized appreciation can be so clearly stated that readers of financial statements are not thereby misinformed. It is obvious that statements based on market values may be misleading if the pertinent information is not clearly set forth but the same may be said for statements based on cost values. Both the method of presentation and the basis of valuation are important; a satisfactory solution of the first problem should not preclude consideration of the second.

[24] In the early years of investment company development, security profits and losses were frequently included in the income statement. This procedure was accompanied by many unsound reporting practices. In some instances profits were shown in the income statement but losses were carried to reserves established from surplus—frequently from capital surplus. Some companies included items as profits which were not properly so classified, such as artificial "gains" on securities of affiliates. In many instances the security profits included in the income statement were not labeled so as to indicate their nature. There has been a tendency for the criticism of such abuses to be extended into a general criticism of the policy of reporting security profits and losses in the income statement. It must be admitted that it is easier to exaggerate the results of profitable operations if security profits are so included but it is also easier to overstate results of unprofitable operations if security losses are buried in the surplus or reserve accounts. Either method is subject to abuse. The principal reason for including security profits or losses in the income statement is that trading transactions are integral parts of the operations of most management companies. A statement of net income, exclusive of security profits or losses, is but a partial report for a company which conducts even a small amount of trading.

[25] The New York Stock Exchange has recommended that profits or losses on security transactions be carried direct ". . . preferably to a properly designated reserve account, or else to a special surplus account which should be a segregated part of the earned surplus." New York Stock Exchange, *op. cit.* This procedure is supported by Niven, *op. cit.*, p. 284. The Forms of the SEC which are applicable to investment companies provide for but do not require the inclusion in the income statement of profits and losses on security transactions.

interest, dividend, and commission income.[26]

The argument has frequently been advanced that investment companies should not consider their profits from sales of investments as income available for distribution but should use such profits to create investment reserves. This argument is apparently based on (1) the observation that over a period of years security profits are approximately balanced by security losses, and (2) the profits made from transactions in a rising market are needed for reinvestment at the higher price level and hence are not profits available for dividend distribution. This argument may be challenged on numerous grounds but, irrespective of its merit, is based on financial policies rather than on accounting principles. Economic and financial considerations may dictate that security profits be retained to provide for subsequent security losses, but security profits ordinarily must be considered as earned from the standpoint of accounting, and as available for distribution in the absence of unusual restrictions of a legal nature.[27] However, it should be noted that this conclusion is reached without considering the relative merits of the various methods of computing security profits and losses. The question of retaining profits to provide for subsequent losses would be very different, for example, if security profits and losses were computed on the last-in first-out basis as contrasted with the first-in first-out method.

The principal exception to the generalization stated above regarding security profits relates to "profits" from the sale of securities which are carried at less than cost. Many of the existing investment companies have restated their securities at market values prevailing at some date subsequent to dates of purchase. In many cases these values are low in relation to market prices of succeeding periods, and consequently these companies may show substantial profits on sales of investments by virtue of prior write-downs. If the original purchase cost were used such profits would be reduced or might be changed into losses. So-called security "profits" computed or written-down values are frequently reported with no indication of the amount of profit or loss which would have resulted if the computation had been made on the basis of cost. This method of reporting does not tell the whole story.[28] The investor is entitled to know the results of the investment company's operations, both on

[26] This information is important for investors and, ideally, should be provided. However, certain practical problems must be recognized if separate divisions of earned surplus are to be maintained and if the source of dividends is to be stated. As an example a stock may be sold for more than carrying value just before the declaration of a dividend; the resulting "gain" must be allocated to either undistributed income from dividends or to security profits. Similar problems may be raised in connection with stock dividends. Theoretically the resulting profits or losses can be allocated with exactness to the appropriate sections of earned surplus, but in practice there may be no such clear-cut line of distinction.

[27] The reporting of security profits and losses also involves the difficult problem of assigning responsibility for them to management or to uncontrolled market movements. Each transaction in securities may reflect an element of profit or loss attributable to management's good or bad judgment, and an element of profit or loss attributable to market movements which are unrelated to the management's investment policy. In times of comparatively stable and selective markets, managerial skill tends to assume greater importance; in times of wide and violent market swings, the importance of market movements may overshadow the efforts of management. It may be possible to allocate virtually the entire profit or loss from a financing operation, or investment in a specific situation, to managerial skill; the bulk of profit or loss from short-term trading may be clearly derived from market movements.

As a practical matter the composite of security profits and losses cannot be successfully allocated between management and uncontrolled market movements. It is possible, however, to compare the results of a particular company with some general index of market price movements. Some companies are presenting information of this type, usually in the form of a chart, to their stockholders. Unfortunately, these comparisons are not always entirely successful for lack of comparability between the portfolio securities of the investment company and the make-up of the market average.

[28] See Werntz, *op. cit.*, pt. II, pp. 914, 916–917.

the reorganized basis and on the former cost basis.[29]

Complete disclosure regarding security profits and losses is needed for any type of investment company and, between the various types, is of most importance for management companies. It is not good financial reporting to hold one's self out to the public as an expert in appraising inherent possibilities in speculative situations, or as an expert in market trading, and subsequently report results of operations on the basis of book values which are less than cost. The fact that stockholders have approved the write-down and are made aware of the aggregate amounts written off does not necessarily mean that stockholders can bridge the gap between the write-down and later financial statements and determine how well the company has fared on the basis of cost before restatement.

The method of computing security profits and losses is also of great importance to investors, particularly when comparisons are made between statements of different companies of the same type. The selection of the method, average cost, first-in first-out, identified certificate, or any of the many hybrid methods which have appeared in financial statements in recent years, is not a reporting problem except to the extent that investors can fairly demand reports which are comparable in method between companies. The choice of methods of computing security profits and losses has probably received more attention than any other single phase of investment company accounting. Organizations such as the New York Stock Exchange, and the great majority of the writers on this subject, have expressed preferences for the average cost method, but income tax requirements stress the identified certificate method with the first-in first-out method an alternative if the former cannot be used. The investment company is forced to choose between these two positions. The investor should demand, as a minimum, that his company state clearly the method used; and as a maximum, that investment companies of a comparable type follow substantially the same method of computing security profits and losses.

REPORTING REDEMPTIONS OF SECURITIES—OPEN-END COMPANIES

Open-end investment companies issue securities which are, with certain exceptions, redeemable at current asset values.[30] This redeemable feature is seldom found in securities issued by companies in other industries and is not entirely consistent with our theory of corporate accounting.

The accounting for equities of shareholders customarily proceeds on the theory that the corporation is a continuing entity which can survive temporary economic crises; the investment value of its securities is not considered as fluctuating in direct proportion to fluctuations in the market value of its assets. Securities issued by investment companies of the closed-end type are based on this concept. However, the open-end company offers to security

[29] Two exceptions to this statement should be noted. An investor who purchases securities of an investment company after the portfolio has been written down, to reflect lower market quotations, is investing on the basis of the reduced values, and he is interested in security profits or losses which are computed on the written-down basis. He might also be interested in the results computed on the basis of cost, but such information is of less immediate significance. An exception to the general statement above must also be made for investment companies which have effected a thorough-going reorganization and have restated securities values on the basis of market quotations at the time of reorganization.

[30] Various provisions have been included, in charters and indentures, which limit the right of redemption. As an example, incorporated companies usually provide that shares may be redeemed only if surplus, or funds, are legally available, and frequently provide for suspension of the redemption privilege when specified stock exchanges are closed. The restrictions on redemptions provided by 38 open-end companies are outlined in Senate Hearings, *op. cit.*, pt. II, pp. 985–991.

holders the privilege of redemption and thus has many of the characteristics of a mutual association of investors with an indefinite life tenure, the investment value of its shares increasing or decreasing with changes in the market value of the company's assets.[31] Consistent with the mutual association concept, the shareholder who retires at a loss may be considered to have absorbed his share of the losses which the association has suffered since he purchased such shares. This loss may represent either operating deficits, or more probably, the unrealized decline in value of portfolio securities. In either event his redemption price will be less than his purchase price, and the difference is his loss. From the viewpoint of the company, such difference between contribution and redemption is a discount which is occasioned by the decline in the net assets per share for the outstanding shares. The stockholder, by retiring at a discount, has assumed his pro-rata part of the decline in net asset value and the discount may be regarded as a proper offsetting item to realized losses, or to unrealized depreciation of security values. Likewise, the shareholder who retires his interest at a premium may be considered to have received his share of the profits which the association has enjoyed but not distributed since he purchased his interest. His gain, the amount of the premium, may have resulted from any income received in prior periods but not distributed, or, more probably, from unrealized appreciation of security values. In either event the redemption price includes a payment for his share of the increase in net asset value and his premium may be regarded as a distribution of realized income, or as a distribution of potential security profits in advance of realization. If the redemption premium is the result of unrealized appreciation of portfolio securities, such premiums are proper offsets to the record of security transactions of the company which will reflect any realization of the appreciation which occasioned the premium.

Redemption discounts and premiums are frequently of great importance, both to the company and to the remaining stockholders, yet these items have generally received little attention either in the reports or the accounts. Redemption discounts, for example, may not even be reported. The current practice, in many instances, is to remove from paid-in surplus only the excess of the redemption price (excluding equalization payments) over the stated value.[32] Any amount representing redemption discount is left in the paid-in surplus account. This procedure is accurate if only the historical presentation is desired. Credits representing redemption discounts were originally contributed by stockholders, and in that sense are part of the paid-in surplus received by the company during its existence. However, redemption discounts are not part of the paid-in surplus associated with the remaining outstanding stock, and ideally, any such discount would be transferred from paid-in surplus to a separate capital surplus account.[33]

Redemption premiums, as indicated, are payments for the retiring shareholder's

[31] Open-end companies have redeemed large amounts of their shares. As an illustration, 15 open-end companies located in Boston received from the sale of their shares to December 31, 1939, approximately $437,-000,000, and paid back in redemptions approximately $122,000,000, or 28% of the aggregate sales. Testimony of Merrill Griswold, Senate Hearings, *op. cit.*, pt. II, p. 489.

[32] Niven, *op. cit.*, p. 283.

[33] This procedure might, in practice, result in some complicated reporting problems. Some writers have recommended the maintenance of only three sections of capital such as the following:

1. Capital stock, at par or stated value
2. Surplus (to include capital surplus and security profits and losses)
3. Undistributed net income (exclusive of security profits and losses).

See "Discussion of Papers on Investment Trust Accounting," *The New York Certified Public Accountant*, February, 1940, p. 292.

pro-rata part of all undistributed income and profit of prior periods, or are payment for his share of increased security values which are not yet realized. The redemption price will necessarily be greater than the combined stated value and paid-in surplus per share, but is, nevertheless, frequently charged to paid-in surplus. This procedure is not strictly accurate, even in the case of the company which has only common stock outstanding, since the remaining paid-in surplus per share does not accurately measure the average pro-rata stockholder contribution. When senior issues are retired at a premium a further point is involved. The redemption price for the senior issue is, of course, properly charged first to stated value, and to paid-in surplus applicable pro-rata to this class. The redemption premium will be the excess of the redemption price over these charges and this excess should not be charged to paid-in surplus applicable to other issues. A redemption premium on either a senior or junior issue is in the nature of a dividend and should be charged to undistributed income. If separate sections of the earned surplus account are maintained, the charge should be allocated to the two sections according to the source of the increase in net asset value which occasioned the premium.

The amount of paid-in surplus which is applicable to a particular share or block of shares may be difficult to determine. This problem could be handled by maintaining records which would enable the investment company to determine the price received for the particular shares surrendered. However, a more practicable approach is to assume that the prices paid by individual stockholders are fairly measured by the average of the prices at which various sales are made. Shares can be sold more easily on a rising market than on falling markets,[34] but if we assume that approximately the same number of shares is sold in each case, then individual redemptions can be compared with the average capital surplus per share.

It is difficult, from a stockholder's viewpoint, to determine the meaning of a sum of discounts or premiums or the difference between two such aggregates. An aggregate of redemption premiums indicates generally that shares have been redeemed at times when the market value of portfolio securities has appreciated above the values prevailing when the "average" share outstanding was sold by the investment company. The retiring shareholder owns a pro-rata part of the increased assets and unless the portfolio has been liquidated at the increased price level and held in cash, or reinvested at this level, the increase in value of the retiring shareholder's interest includes at least some unrealized appreciation. Accordingly, the premium he receives may be payment for both realized and unrealized security appreciation. Theoretically, the company will liquidate portfolio securities in order to redeem its own shares, and if the retiring stockholder's pro-rata part of the portfolio could be sold the company would realize approximately his part of the unrealized appreciation, and redemption premiums and security profits would thus tend to offset one another. Actually, the company may not liquidate investments in order to redeem its own shares and even if it does sell portfolio securities it will necessarily sell blocks of specific securities and not a pro-rata part of all holdings. Consequently, the retiring stockholder may receive payment for unrealized appreciation at the same time that the company is realizing profits of a different amount, or perhaps even realizing losses

[34] "The great volume of sales of investment trust securities, from 70% to 90%, are made on a rising market—that is, when the next day's price will be higher than the present price. When the market is down—nobody wants to buy." Bane, *op. cit.*, pt. I, p. 138.

by selling specific securities which have depreciated below cost.

Discounts on redemptions may occur principally because the market value of portfolio securities has declined below cost. Theoretically, portfolio securities would be sold to provide funds for redemptions, and again if a pro-rata part of the portfolio could be sold the company would realize security losses approximately equal to redemption discounts. However, this may not occur in practice and redemption discounts may be recorded in the same period when security profits are recorded.

The amounts of either security losses and redemption discounts, or security profits and redemption premiums, can seldom be directly compared despite the logical relationship of the items. This lack of agreement of the amounts is of little importance to the retiring stockholder. He owns a pro-rata interest in the company, and it is immaterial to him whether the portfolio securities are liquidated at date of redemption or are held as investments. In either event he receives his pro-rata part of the assets at market value.

To the remaining stockholders and to prospective stockholders the agreement or lack of agreement of amounts of security losses and redemption discounts, or security profits and redemption premiums, may be of great importance. This is particularly true when redemption premiums are paid but investments are not liquidated at the increased values and the investment company does not sell its own securities to offset the redemptions. In such cases the retiring stockholder receives payment from current funds, the investments are unchanged, and the remaining stockholders have each, in effect, exchanged an interest in current funds for an increased interest in unrealized appreciation of security values. The situation may be quite different if the investment company sells a sufficient number of its own securities to equal the shares redeemed at premium prices. It is possible in this situation that investments might be sold to provide funds for redemption, and the proceeds from the sale of new securities might be invested. Consequently, there might be some correspondence between the redemption premiums and security profits. This situation is complicated, however, if the payments made by the new stockholders are, in effect, paid over to the retiring stockholders. The new investors might be regarded as buying the unrealized appreciation of the old, but nevertheless the redemption premiums should be treated as charges to the record of security transactions, and the payments for the new shares credited to stated value and paid-in surplus.

There are obviously a large number of possible combinations of items and amounts relating to redemptions of securities and transactions in investments by open-end companies. Despite the lack of agreement of the aggregates, there is, as indicated above, a general relationship between the items of realized security profits and losses and redemption premiums and discounts. The importance of this relationship to the remaining stockholders may be illustrated by the following example:

A company sells 10,000 shares at \$10 per share and credits \$9 per share to paid-in surplus. Subsequently, one-half of the portfolio consisting of *X* securities declines 40%, and the other half consisting of *Y* securities appreciates 20%. The market value of the total portfolio would be \$90,000, a 10% decline. The company now redeems 1,000 shares at \$9 per share and secures funds by selling *X* securities, cost \$5,000, for \$3,000, and *Y* securities, cost \$5,000, for \$6,000. There is a net loss of \$1,000, which is exactly offset by discounts on redemption. The net loss and discount in the illustration given are clearly related.

In the illustration above 1,000 shares

are redeemed at $9, compared with a contribution of $10 per share. If the usual corporate procedure were followed this difference of $1,000 would be treated as additional capital surplus. The company also realized a security loss of $1,000 as the result of liquidating investments to provide funds for redemptions. This security loss, according to usual corporate procedure, would be shown in earned surplus. If this procedure were followed when large redemptions were being made in depressed markets, large credits would be made to capital surplus for redemption discounts but earned surplus would be charged with realized security losses. This recording process would apparently deny that the credit to capital surplus resulted only because of the existence of security losses. Some companies have attempted to solve this problem by carrying security losses to capital surplus. If security losses were only occasioned by liquidations of investments to provide funds for redemptions, and were approximately balanced by redemption discounts, this procedure might have merit but in too many instances this procedure has been utilized to absorb in capital surplus large security losses which have not been occasioned by redemptions of the investment company's own securities.

If a separate surplus account were maintained for security profits and losses, the results of security transactions and redemptions might be presented in the following manner:

Paid-in Surplus applicable to outstanding shares
Undistributed Net Income
Security Profits and Losses:
  Security Profits
    Less, Premiums paid on redemptions
  Security Losses
    Less, Discounts on redemptions
  Net Security Profits and Losses adjusted for redemptions.

This treatment would reflect these items in their proper relationship but would require a somewhat unusual adjustment of Paid-in Surplus since this account would be reduced by the average amount per share for each share redeemed even though that might be greater than the amount of cash actually paid on redemption. Consequently, Paid-in Surplus would represent on the average the amounts received in excess of par or stated value on all the shares still outstanding but would contain no part of the contributions by shareholders who have withdrawn.

A further problem in this connection is raised if security profits and losses are reflected in the income statement. If the net security loss in the illustration given above is shown in the income statement, the remaining shareholders can reasonably assume that part of such loss is applicable to their shares. Actually, all of this realized loss has been absorbed by the retiring shareholders. From this point of view the situation would be more clearly stated by offsetting the net security loss and redemption discount in a separate surplus account rather than by showing security losses in the income statement. However, in the majority of cases there may be no such clear-cut relationship between the effects of redemptions and security transactions on capital and surplus. As a general procedure the results of security transactions are preferably shown in the income statement even though this may result in particular cases in showing amounts as profits or losses which have been entirely absorbed in redemption. This latter difficulty is only partly met by establishing a separate surplus account to include security profits and losses and redemption premiums and discounts.

REPORTING REDEMPTIONS OF SHARES—CLOSED END COMPANIES

The above discussion of redemption premiums and discounts relates to open-

end companies. Closed-end companies may also redeem their securities, either by direct negotiations with stockholders or by purchases in the market. The redemptions of shares by closed-end companies, unlike those of open-end companies, may be made at discounts which are greater or less than the pro-rata part of the existing unrealized depreciation of portfolio securities. An excess of discount on such redemptions over any realized or unrealized depreciation on the retired shareholder's pro-rata part of the portfolio, does constitute a gain to the remaining shareholders,[35] and treating it as such is consistent with our usual concept of corporate accounting. However, there is the possibility of a more refined treatment of credits in the accounts and reports of closed-end investment companies than is possible for companies of other industrial types. To illustrate, assume a company has no operating deficit and the net value of its shares has declined 5%, but it purchases its own securities at a discount of 20%. The remaining stockholders obviously gain by approximately the difference, i.e., 15% of the book value of the shares retired. Theoretically, security losses might be shown as related to that part of the redemption discount which can be attributed to the decline in value of the portfolio, i.e., one-fourth of the redemption discounts, but the remaining portion of the discount should not be used to absorb security losses.[36]

DIVIDENDS, AND DISTRIBUTABLE INCOME, OF MANAGEMENT COMPANIES

The economic tests which seem reasonable in determining income available for distribution are, with one exception, the same for both closed and open-end diversified management companies. The single exception relates to redemption premiums and discounts which require additional consideration in connection with the dividend policy of open-end companies. However, closed-end diversified and non-diversified companies differ, from the standpoint of dividend policy, as to the treatment of security losses and profits and unrealized depreciation of investments.

DIVIDENDS—CLOSED-END MANAGEMENT COMPANIES

As a group, closed-end diversified companies may receive income from interest and dividends, underwriting commissions and other fees, and from profits on sale of investments. Income in the form of security profits is irregular both as to occurrence and amount. The most stable part of their income is interest and dividends received and dividends are logically paid from such income irrespective of the results of security transactions.[37] Fees and commissions, including income from underwriting activities, are of a different nature and should be separately stated in the income accounts but, from an economic point of view, can be included with interest and dividends

[35] Total repurchases by all types of closed-end companies (including investment-holding companies), in the years 1927–35, amounted to approximately $534,000,000. SEC Report, pt. II, p. 233. This total was divided into approximately 20% each for common stock and bonds, and 60% for preferred stock. The combined repurchases were made at discounts below asset values of more than $100,000,000. Testimony of L. M. C. Smith, Senate Hearings, *op. cit.*, pt. II, p. 801.

[36] One possible exception to this generalization should be noted. Assume an investment company retires all of a single class of stock, for example preferred stock, at a discount which is in no way related to existing unrealized depreciation of assets. A capital surplus results from such discount on retirement of an entire issue. There are no remaining shareholders who can claim that they contributed any part of this surplus. Such capital surplus, from the standpoint of the remaining stockholders, is clearly a gain, although it is not "earned" in the operating sense, and has many of the characteristics of earned surplus. However, current accounting thought would probably not sanction the transference of capital surplus of this character to earned surplus.

[37] Werntz, *op. cit.*, p. 908. Despite the logic of this approach it is possible that such a dividend policy might lead to absurd results. Dividends might, for example, be continued from current income, with no provision for security losses, until the assets were virtually all distributed.

received for the purpose of dividend distributions.

If market values are included in the final extensions of the balance sheet, as is suggested above, unrealized appreciation or or depreciation will be directly reflected in the capital and surplus section.[38] Any unrealized appreciation reflected is not, from the viewpoint of accounting, to be regarded as available for distribution in the form of dividends although it may perhaps be legally available in some jurisdictions. Some interesting theoretical considerations are involved in this treatment of unrealized appreciation but a problem of more practical importance arises when unrealized depreciation is reflected in the statements.

As indicated above, dividend distributions from current interest and dividend income need not be restricted because of security losses or unrealized depreciation, but this reasoning may not apply to dividends from security profits if unrealized depreciation exists. There is also the related problem of deciding whether, for this purpose, unrealized depreciation on some securities can be offset against unrealized appreciation on others. Diversified companies are not ordinarily trading companies and are not primarily interested in trading profits, but net security profits are clearly realized income and are ordinarily available for distribution. However, it does not seem sound economics to consider net security profits as available for distribution except to the extent that such profits exceed the amount of unrealized security depreciation.[39] Current market quotations are in general the most objective criteria for marketable securities, and the maximum dividend distribution which seems reasonable from security profits is the amount by which security profits are in excess of security losses and net unrealized depreciation.[40]

Non-diversified companies differ in many of these respects from diversified companies. In the past an occasional non-diversified company has emphasized short-term market trading; other companies

[38] The adjustment of security values from cost to market is an important part of the balance sheet display, and if clearly stated, should amplify the reported facts regarding dividends and earnings. The adjustment of security values might be shown as follows:

Marketable securities, at cost to the company	$1,500,000
Less, unrealized depreciation based on market quotations as of 12/31/39	200,000
Marketable securities, at market quotations as of 12/31/39	$1,300,000

These adjustments necessitate corresponding changes of the equity accounts, such as the following:

Capital Stock	$1,000,000
Paid-in Surplus	300,000
Undistributed Net Income	100,000
Undistributed Security Profits	100,000
Total Capital and Surplus, before deducting unrealized depreciation	$1,500,000
Less, unrealized depreciation of marketable securities, based on market quotations as of 12/31/39	200,000
Total Capital and Surplus, adjusted to market quotations as of 12/31/39	$1,300,000

Adjustments for unrealized appreciation, less estimated income taxes, would be added to the cost values of portfolio securities and to the sum of the equity accounts as expressed on a cost basis. Schreiber, *op. cit.*, p. 255, discusses the entries needed to supplement the illustrated balance sheet treatment. Niven, *op. cit.*, p. 286, recommends showing net unrealized depreciation or appreciation of investments as a segregation of surplus. This procedure might result in a clearer statement under some circumstances, particularly from the standpoint of dividends and distributable income, than would the method illustrated above, but in general unrealized appreciation or depreciation seems more properly shown as an adjustment of the entire equity balance.

[39] See Discussion of Papers on Investment Trust Accounting, *op. cit.*, p. 295; also the New York Stock Exchange, *op. cit.*

[40] This method of determining income available for distribution would not only result in a realistic dividend approach but also has the advantage of offsetting unsound methods of determining security profits or losses. Regardless of the method of computing security profits or losses, the sum of realized and unrealized depreciation would be the same. Consequently the same excess of security profits over realized and unrealized depreciation would be determined no matter what method of determining profits is employed. This fact, however, does not remove the need for an accurate determination of security profits and losses, and cost of the remaining portfolio. An item of security profit or loss in the income or surplus statement is different to many readers from a similar amount of unrealized depreciation or appreciation in the balance sheet. See Werntz, *op. cit.*, pt. II, p. 911.

may concentrate investments in speculative situations which offer the possibility of large appreciation. To the extent that trading activities are emphasized, interest received may be irregular, and dividends received may be more or less accidental depending on whether a security is held at the dividend date. For the companies which invest in special situations, interest and dividends may be regular and recurring in some instances and perhaps irregular or non-existent in others, depending on the type of "situation" in which the different companies have invested. Annual income from these special investments is at best likely to be small, the company investing for appreciation rather than for current income.

The suggestion is made above that diversified companies may, from an economic standpoint, pay dividends from interest and dividend income irrespective of security losses or unrealized depreciation. This conclusion is not applicable to non-diversified companies. Security losses and unrealized depreciation are too closely allied to the principal functions of these companies to consider interest and dividend income alone without adjusting for changes in security prices and realized losses. The amount of income available for dividends for these companies should be determined by (1) net income from interest dividends, and commissions,[41] (2) net realized profit and loss on security transactions, (3) net unrealized depreciation of portfolio securities.

The item "net unrealized depreciation" is the difference between aggregate market and cost of marketable securities which would include appreciation on some securities as offsetting depreciation on others. Of course, this item need not be included in the income statement except by note or reference. Net profit or loss transferred to earned surplus would thus be determined by comparison with cost, and provision for unrealized appreciation or depreciation would be made by adjusting portfolio securities and capital and surplus to market value.

DIVIDENDS—OPEN-END DIVERSIFIED COMPANIES[42]

The determination of income which is economically available for the payment of dividends by an open-end diversified company differs in only one respect from the method outlined above. Net income from interest, dividends, and commissions, net security profits, and unrealized depreciation of marketable securities would be combined as suggested. In addition, redemption discounts and premiums must also be considered. Redemption discounts, as outlined, are properly offset against security losses or unrealized depreciation, and redemption premiums are distributions of realized security profits and advance distributions of unrealized appreciation. Accordingly, the income of an open-end company, economically available for distribution, is logically the result of all of these items, as follows:

Income from sources other than security profits
Profits on the sale of investments
Less, premiums paid on redemptions

[41] Net income from interest, dividends, and commissions is usually reported with all expenses assigned against this income. In particular instances the trading and investigating activities may be sufficiently important to justify allocating part of the expenses to such operations, but financial statements seldom separate any item other than income taxes. A similar allocation of expenses might be made by diversified companies but there is probably less reason because of the lesser relative importance, compared with non-diversified companies, of trading and investigating activities.

[42] Open-end nondiversified companies have not been considered in this study. Such companies might be formed, but the writer does not know of any such companies in existence at the present time. The redeemable feature of shares of open-end companies would endanger the existence of a company which undertook extensive market operations or large investments in "special" situations.

Losses on the sale of investments
Less, discounts on redemptions
Unrealized depreciation of marketable securities

The item of redemption discounts may appear to be out of place in this arrangement. Redemption discounts, as suggested above, can be regarded as reducing the depreciation of security values which occasioned the discount. This procedure results in showing the same amount of income available after deducting unrealized depreciation as if the redemption discounts had been treated as directly available. However, this method has the merit of indicating the relationship of redemption discounts to security losses and unrealized depreciation.

Open-end companies also receive equalization credits but no particular reporting problems are raised by these items. Such payments are made to equalize the entering shareholder's interest with that of the existing shareholders in the undistributed income, and dividend distributions in subsequent periods properly represent refunds of such credits. Similarly, if a shareholder retires between two dividend dates he receives his part of the accumulated income. These distributions are divisions of dividend and interest income and are not affected by security losses or profits.

The above discussion of distributable income is based entirely on economic considerations. In most instances the requirements of state incorporation acts, of articles of incorporation, and of indenture restrictions, are much less stringent than the tests outlined above. The economic tests proposed seem reasonable despite the fact that legally most of them can be ignored by investment companies.

There is one further point to be considered with respect to open-end diversified companies which qualifies the conclusions advanced. Open-end diversified companies which qualify as "mutual" companies under Section 361 of the Internal Revenue Code are given preferential tax treatment. In order to qualify a company is requried, among other things, to distribute to its stockholders in the form of taxable dividends during the taxable year " . . . an amount not less than 90 per centum of its net income. . . . "[43] Taxable income and net profits for shareholders may be computed on different bases and the advantage to be gained by qualifying as a mutual company may cause an investment company to pay, as taxable dividends, amounts which would not be considered as available for dividends from an economic point of view.

NEW FORMS OF FINANCIAL STATEMENTS

Recently a number of investment companies have experimented with new forms of statements, and other companies have modified to fit their needs the customary forms of financial statements. Most of this attention has been directed towards the balance sheet and surplus statement.

The annual reports of the National Investors Corporation, an open-end company, include some interesting financial statements.[44] This company presents statements of operations, of assets, and details of expenses and taxes. The Statement of Operations summarizes the various factors of income, expenses, dividends paid, realized security losses, capital withdrawals, unrealized appreciation, and miscellaneous adjustments, which modify the net assets of the last reporting period. The change in net assets during the year is stated in an

[43] Section 361 (a) (4), Regulations 103, Bureau of Internal Revenue, U. S. Treasury Department. The preferential treatment accorded "mutual" companies is apparently based on the theory that such companies merely act as conduits through which individuals invest, indirectly, in corporate stocks. The events leading to this tax treatment are detailed in Senate Hearings, *op. cit.*, pt. III, pp. 1076–1082.

[44] These comments are based on the annual report for 1938, National Investors Corporation.

aggregate amount and is also expressed in dollars per share. The Statement of Assets includes the investments in common stocks stated both at income tax cost and adjusted for unrealized appreciation. All equity accounts are combined in one amount which is stated on the basis of market value for investments in common stocks.[45] The components of this equity balance are stated in a note which sets forth the balances for capital stock, capital surplus, income surplus, security profits deficit, and unrealized appreciation. This is a distinct departure from the orthodox method of including the separate equity balances in the balance sheet and is, perhaps, an indication that the detailed equity accounts are of little importance to stockholders. The orthodox method of including in the balance sheet the various equity balances is presumably based on the assumption that such information is of importance in tracing the progress of the company. Unfortunately, the information presented is seldom sufficiently complete to serve this purpose. The most that is generally shown is the ending balances of the preceding period and the changes in the current period. These balances are, for many investment companies, meaningless from accounting, economic, and legal points of view, and if no additional information is to be shown, the account balances might as well be totaled and the details shown in a note.[46]

An example of a different type of presentation is found in the reports of the Century Shares Trust.[47] The balance sheet includes parallel columns for market and cost values of investments, with the cost balances used in the final extensions. The equity balances, with the exception of the amount available for distribution, are included in one amount labeled "capital accounts." This single figure is supported by a separate statement which provides for the following information:

Shares outstanding, representing proceeds from sales of shares, exclusive of amounts set apart to equalize amount, per share, available for distribution, plus amount capitalized for shares issued as a stock dividend in 1929, less average paid-in value of shares purchased and retired:
  Balances at beginning of period
  Proceeds from sales of shares in the period
  Less average paid-in value of shares purchased and retired in the period
  Balance at end of period
Credit from retirement of shares repurchased (excess of average paid-in value over capital amount paid for shares repurchased):
  Balance at beginning of period
  For shares repurchased during the period
  Balance at end of period
Balance of profit and loss from scale of investments, based on federal income tax costs:
  Accumulated net loss at beginning of period, including$— distributed to shareholders from profits prior to —
  Realized net profit (loss) in period
  Adjustment of cost basis of investments sold in prior period
  Balance net loss at end of period
Total capital accounts on basis of carrying investments at cost at end of period
Excess of cost of investments over market value at quoted bid prices at end of period
Total capital accounts based on market value at quoted bid prices of investments at end of period

The statements of the National Invest-

[45] The annual report of Incorporated Investors for 1939 also illustrates this type of presentation. The single figure for equity accounts, or "net resources," is stated on the basis of market quotations. This single amount is supplemented by a "Statement of Capital and Surplus" which includes the following balances:
  Capital Stock (details of shares outstanding, etc.)
  Paid-in Surplus, per accompanying statement
  Undivided Earnings, per accompanying statement
    Total Capital and Surplus on cost basis
  Unrealized Depreciation
    Net Resources, on basis of market quotations.

[46] For a discussion of the current balance sheet display see William W. Werntz, "Subjects for Accounting Research," an address delivered before the American Institute of Accountants, San Francisco, September 20, 1939. See also Lewis A. Carman, "Primary Accounting Concepts," *Journal of Accountancy*, Vol. 61, for a discussion of the purposes of financial statements.

[47] See the prospectus dated May 17, 1940, of Century Shares Trust, an unincorporated open-end management trust.

ors Corporation depart from the orthodox forms by placing less than the usual emphasis on equity balances; the statements of Century Shares Trust offer more information than is customarily found in financial statements. The Statement of Capital Accounts provides for the transfer from contributed capital of any redemption discounts, and reflects the balance of all such redemptions. The aggregate of realized security profit or loss is reported separately, and the amount of dividends charged to security profits is stated. The total of all equity balances is stated both on cost and on market basis. This information is essential to an intelligent appraisal of the merits of an open-end investment company.

The majority of our investment companies have adopted the forms of financial statements which they found in current use by other types of business. A comparison of the statements developed by National Investors Corporation and Century Shares Trust suggests that more intelligible forms of financial statements can be developed which will fit more closely the needs of investment companies. There is, however, one danger which may be encountered if too many variations are attempted. One of the essentials of any financial statement is that it be comparable, both with prior reports of the same company, and with current and prior reports of other companies in the same field. Revised reports should not depart so radically from earlier statements that valuable comparisons cannot be made.

CORPORATE SURPLUS POLICY AS A FUNCTION OF MONOPOLY

PAUL M. VAN ARSDELL

TWO PRIMARY conditions prompt inquiry into the problem of corporate surplus policy in its relation to monopoly: (1) the nature of antimonopoly attacks on corporate surplus policy and practice and (2) the recent singular lack of progressive and constructive literature on corporate financing.

In general the antimonopoly offensive has not been focused on corporate surplus entrenchment; in particular instances, however, the attack has precisely sought out corporate practice with respect to retention of earnings—or surplus accumulation—as its objective. Perhaps corporate surplus policy was to be "taken in the stride" of social reform; perhaps it was a a mere segment of the general goal of antimonopoly crusading. But in any case, corporate practise with respect to retention of earnings has been a target, though probably—and perhaps fortunately—never a principal target of antimonopoly firing. And so far, students of monopoly and its near relatives, oligopoly or monopolistic competition, have taken the initiative in the skirmish. Attention on the corporate surplus problem has come recently by way of investigating monopolistic practice and tendency, rather than by way of studying corporation finance. The social-reform role has been a principal factor inducing the criticism of earnings retention by corporations; the part of private financial management has provoked meager consideration and comment.

The second condition which prompts inquiry into this subject becomes signifi-

cant here and is related, perhaps closely, to the social-reform nature of objections to surplus retention. This second condition is that of the recent absence of progressive literature from the standpoint of private corporate finance. New textbooks and revisions of old textbooks in corporation finance have appeared in the past decade, but scientific contributions have been at a minimum. It is true that the general literature on social control of corporations has been fairly abundant in the past decade. But this material has dealt primarily with criticism and attacks upon the corporate system. It has been concerned largely with seeming evils in our economic and social structure which allegedly are attributable to the modern corporation regime. Probably a need for increased regulation of corporations is a natural complement of a maturing national economy. That attention of students of social problems should be directed in recent years toward a more rigorous policing of the economic system is logical; that appeal for reform of the corporate system should be most urgent in periods of economic stress is in accordance with human nature.

Nevertheless, it is an oversight to infer that private corporations have not had particular financial problems of their own—problems especially incident to the gyrations of the economic cycle. The swings of the cyclical pendulum not only have magnified for society the problem of the corporation; the cyclical upheavals have magnified for the corporation the problem of private finance. In brief, the economic maladjustments of the past decade have brought much attention to the problem of social control of the corporation, with monopoly a general theme of the corporate reformers; perhaps a somewhat neglected phase of these same maladjustments has been the problem of corporate financing.

In view of these conditions, it is fitting to reverse the current reform approach to the corporate surplus problem by inquiry into the subject on the basis of the financial functions of corporate surplus. Instead of an appraisal of retention of earnings from a standpoint of monopoly evils, it seems appropriate that investigation proceed along the lines of the primary functions of retained earnings. This approach adopts the viewpoint of the private corporate financier instead of the socia reformer. It does not preclude, however, evaluation of corporate surplus policy in the light of both private and social implications.

FUNCTIONAL NATURE OF CORPORATE SURPLUS[1]

Corporate surplus arises primarily by retention rather than disbursement of earnings; from an accounting view it constitutes the excess of corporate assets over corporate liabilities and capital stock. Accountants have classified surplus variously, usually with emphasis on its sources and legal availability for dividends. Yet, a classification of surplus based on its financial functions is essential to understanding of its private and social implications. Fundamentally, corporate surplus serves three financial purposes: (1) a source of expansion capital; (2) a buffer for business risk; (3) a basis of dividend distribution. Its use as a primary source of capital for expansion has depended, of course, on the retention of earnings in business and is evidenced strongly by the history of many American manufacturing firms. Unquestionably, corporate growth by this means has the merit of avoiding the perils of bonded debt; even the accumulation of cumbersome and embarrassing contingent senior claims through preferred stock is averted by this method of financing. Expansion by retained earnings also

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[1] See "Problems of Corporate-Surplus Administration," by Paul M. Van Arsdell, Accounting Review, September, 1938, pp. 275–277.

avoids complicating problems of control by leaving undisturbed the existing voting rights. Retention of earnings as a medium of corporate growth has the additional advantage of economy in that it eliminates the cost of marketing new securities. While this method of financing corporate expansion is not well adapted to the developmental needs of many concerns, it has fit the pattern and tempo of gradual expansion by numerous manufacturing firms for which economical financing, avoidance of senior charges, and maintenance of existing control were essential considerations.

Surplus is a logical complement of longevity in corporate enterprise. Without permanent business firms neither the expansion or risk-combatting functions of surplus had primary significance. The joint-adventure enterprise of earlier centuries was restricted in duration to completion, successfully or unsuccessfully, of a single project. Each venture absorbed its own risk, and the problem of business expansion was paramount as long as the firm property was divided among the participants upon conclusion of the project. However, when the separate ventures came to be united in a continuous stream of business enterprise under permanent capital stock, the managerial viewpoint became long-term instead of temporary.

Logical incidents to permanent management were problems of size, problems of business risk—that is, of unpredictable events which occasioned particularly low profits or losses. The general tendency in American business enterprise has been growth, or expansion; relatively few American firms have exhibited a tendency toward contraction. Retention of corporate earnings—accumulation of surplus—was one simple and direct means of facilitating needed expansion. Long-term management, aided by accounting, recognized periodicity, or the time element, as fundamental in the measurement of profit and loss. The natural sequel to the combination of business risk and periodicity of income measurement was management's attempt to offset high profits of prosperous periods against low earnings in depressed periods. Surplus reserves against unpredictable financial reverses were corollary refinements of long-term financial ventures in which management sought consistent income return by buffering unusually low earnings of lean years by excessive profits in other periods.

The interdependence of the expansion and risk-combatting functions of surplus with its dividend function is vital in corporate financial management. Since business firms differ widely as to developmental needs and business uncertainties, no single formula can be given for surplus administration. Business risk and the need for permanent corporate expansion should be weighed against dividend disbursements in the scales of managerial judgment. Minimum risk and expansion needs would justify maximum surplus distribution as dividends from assets; particular business hazards and heavy expansion needs would warrant minimum distributions of surplus in cash and other asset dividends. The stock-dividend device introduces no special problem in this respect; it is merely a corollary to expansion by retained earnings, as it evidences permanency through capitalization of surplus already impounded as the source of expansion capital. Sound disposition of corporate surplus depends upon prudent managerial correlation of the functions of surplus under the particular needs and conditions of the enterprise affected.

Unfortunately, corporate practice in the 1920's involved some glaring misapplications of what probably was sound surplus doctrine. Earnings were retained on a large scale in manufacturing enterprises; in some cases surpluses were built up for expansion, in other cases for combatting

business risk and stabilizing dividends. But whatever the ostensible purpose for the surplus accumulation, financial consequences were disappointing. Retained earnings of the prosperity period displayed a major tendency to seep toward the fixed-property accounts, as the result of heavy industrial demand for physical capital. Liquidity needs were largely overlooked in the contagious optimism of a boom period. That the "roaring twenties" offer many examples of overextension of plant and overstocking of inventory through retained earnings as a primary capital source is a platitude. Intercompany ownership of stock and the holding company flourished in the prosperous era as intermediary devices to facilitate overexpansion. All this is now legend.

Two considerations are significant at this point. In the first place, the depression avalanche of values found corporations expanded by prosperity surpluses far less vulnerable than those expanded by prosperity security sales. In the second place, much of the financial error did not rest in earnings retention but rather in injudicious management of corporate assets. Attention to these considerations is important in that some students of monopoly have neglected them in blanket condemnation of corporate earnings retention.

ATTACK ON SURPLUS ACCUMULATION

The antimonopoly attack on surplus accumulation has centered largely about the importance of the so-called free capital market. It is contended that corporate management should not arbitrarily decide upon expansion by retention of earnings, thereby avoiding the verdict of the market but should disburse practically all corporate earnings as dividends, and raise necessary expansion capital by security sales or by short-term borrowing from the banks. Mr. Arthur Robert Burns states:[1]

> The separation within the group of the functions of management from those of ownership, and the concentration of the former in a few hands, have resulted in fact in a large share of profits being retained in the business; the "owners" have little opportunity to dispose of these profits as they would if the profit were all distributed in dividends; 29.4 per cent of their net income was retained within the larger corporations during the period 1922 to 1927.[2] This retention may be intended to avoid shortages of liquid resources in periods of restricted business or to permit the continued payment of dividends in the absence of adequate current profits.[3] But it also facilitates expansion without the necessity of issuing new securities; those managers who find size attractive can satisfy their desire without having to submit their plans to the test of the capital market.

Perhaps the proponents of the Federal Undistributed Profits Tax carried the spearhead of the general attack on retained corporate earnings. One staunch supporter of this now extinct measure declared that "for large corporations, either *because of existing conditions of monopoly or oligopoly*[4] or because of threatened conditions of that character," this tax should be a part of our fiscal system.[5]

In the writer's opinion, grave doubt surrounds the feasibility of the capital market as "the test" for corporate expansion and financing. The open market reflected excessive optimism in 1927–1929, then excessive pessimism in 1932–1934. Was the strong marketability of stocks in 1927–1929 a rational criterion for corporate expansion? Were the market conditions of 1932–1934 an acceptable barometer of justifiable financing? Can unusual strength in the bond market since 1935 be cited as the logical proof for financing on long-term credit? Might not the very strength of the

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[1] Burns, Arthur Robert: *The Decline of Competition*, p. 10.

[2] Means: "The Large Corporation," *Amer. Econ. Rev.*, XXI: 29 (1931).

[3] That is, stockholders are being converted into low-grade bondholders.

[4] Italics mine.

[5] Smith, James G.: "Economic Significance of the Undistributed Profits Tax," *The American Economic Review*, June, 1938, p. 310.

recent bond market constitute an invitation to overbonding? Fundamentally, to accept the open or "free" market as "the test" for corporate financing is to regard such financing as entirely a matter of expediency. Sound corporate financial policy recognizes marketability as important and admits the fact of situations in which normal financial planning must be tempered by current market conditions, but it does not accept as infallible the judgment of the market.

If overexpansion is an evil, complementary to retention of earnings, it still is not clear that total disbursement of corporate earnings as they emerge would alleviate the difficulty. Retention of earnings naturally occurs in periods of peak profits, when exaggerated optimism over these profits brings excessively high market prices for corporate shares. While earnings are the primary basis for market pricing of stocks, it is well established that the market places a premium on earnings distributed as cash dividends rather than retained. Disbursement of these profits logically would distend the overvaluation effected by the high earnings. As a "test" for merited corporate financing, then, the open market fails, for it would invite by sale of stock—or worse, by sale of bonds—the very unutilized plant capacity so frequently viewed as a counterpart of retained earnings. Of course, assumption of corporate debt through the open market as an alternative to earnings retention may serve to augment overexpansion by the additional burden of overbonding.

Vigorous support has been given the open capital market as an effective means of distributing capital among the various industries. Yet, the practice of surplus accumulation, with its common accompaniment of stock dividends and split-ups, and with reasonably active security exchanges, has hardly proved a serious impediment to the flow of capital in response to basic needs for it. The open market merely reflects the opinions of many buyers and sellers of securities; the speculative fever with which the market has rallied to the cause of holding-company exploitations, oil promotions, and real estate booms hardly attests to the effectiveness of the open market as a safeguard of the public interest.

The separation of management from ownership has been cited occasionally as a condition favoring surplus accumulation and monopoly. It remains very doubtful that disbursement of all stock earnings would have prevented corporate expansion on a large scale. The lure of high income return and a comparative disregard of control privilege facilitated the separation of management from ownership; these same conditions would have admitted large-scale corporate expansion, even monopoly, by sale of corporate securities. Most stockholders, potential and actual, merely seek high profits; their capital is apt to flow in the profits direction. In this respect abandonment of earnings retention seems unlikely to prevent monopoly. It is even doubtful from this angle that a curb on retained earnings would alter materially the concentration of corporate control. The obvious conclusion is that monopoly cannot be curtailed merely by eliminating the practice of retention of earnings. To remove that method of capital accretion would induce other methods, possibly of greater amplitude and hazard. The open market, with its sensitiveness to cash dividends, might actually expedite, rather than curb, the tendency toward monopoly and the mal-allocation of capital among the industries and competing firms. A brief consideration of the financial structures of the natural monopolies reveals the inconsequence of retained earnings in financing public-service enterprises. The general absence of surplus accumulation in these firms suggests that a severing of the retained earnings artery would not restrain

essentially the growth of the monstrous industrial corporation.

The crusaders on monopoly persistently lament the rigidities occasioned by overextension of plant. Tendency toward permanent excess capacity is regarded as conducive to price regidity. Similarly, excessive burden of fixed-charge, long-term securities introduces a rigidity into corporate costs which, too, may have its counterpart in price regidity. Professor Frank A. Fetter, entrenched and vigorous foe of the monopoly masquerade, has asserted the importance of reducing long-term credits of large companies and simplification of their capital structures. What capital structure is more simple than that in the New England style of financing, the essence of which is net-worth financing with retained earnings a principal source of capital accumulation? Moreover, a primary process for simplifying corporate financial structures has been retention of some earnings and application of the proceeds to debt retirement. In this respect the retention of earnings supports, rather than obstructs, the very reform advocated by critics of big business.

The bulk of the antimonopoly attack on surplus accumulation has centered about its overexpansion aspects, which aspects cannot be denied. But retention of earnings is probably the least dangerous and least rapid of the various tributaries to the monopoly stream. Proposals to substitute the judgment of the capital market for that of private business executives in the expansion problem imply an equilibrating magic of the market which may be more apparent than real.

For small corporations in particular, the retained-earnings source of expansion capital should be left open. Retention of earnings for these firms may support rather than suppress competition by allowing an economical and effective means for their growth. Relatively high costs of marketing security issues might preclude their expansion by security sales. If small enterprises grow by accumulating surplus, they avoid prior charges in their capitalizations as well as security marketing costs. The consequence may be an improved competitive basis for them through more effective size, economical financing, and flexibility in capital structure.

The expansion function of earnings retention should not be the only and final basis for evaluating accumulation of corporate surplus. The risk-buffer function of surplus warrants recognition in any appraisal of earnings retention in its financial and social implications. On this point the corporate reformers have been content to emphasize the freezing in operating assets of prosperity-stabilization surpluses, then generally condemn corporate directors for having withheld the excess earnings from stockholders. What evidence is there that the stockholders would have committed those excess earnings more soundly than the directors? The question resolves itself into whether the stockholders or directors are the more prudnet in the administration of excess corporate earnings. At least, the directors are the experts in the field; and expertness in corporate management does nor presume ability merely in production administration, but presumes it also in financial administration.

CORPORATE SURPLUS AND MONOPOLY

Perhaps corporate management itself may have confused the expansion and risk functions of surplus in the dislocations of the 1927–1933 period. But even so, the basic error in corporate-surplus administration in this period was not the withholding of excess-prosperity earnings; the basic mistake was the commitment of the proceeds of these earnings without reference to their liquidity. Had funds from the impounded excess corporate earnings been invested in secondary reserves in the true

sense—that is, in prime investment securities, rather than in operating assets and speculative securities—corporate financial difficulties in the depression years would have been less severe. To eliminate all asset shrinkage from prosperous to depressive periods would be unthinkable in the modern order. That risk cannot be eliminated in the present dynamic society is not controverted. But private management can accomplish much to minimize the drastic effects of risk and the overexpansion of operating assets. Price movements in the market may support sound stabilization-reserve policy, as they create opportunity for investment in protected issues at comparatively low prices, when excess profits provide investment funds, and for their sale at comparatively high prices, when much heavier shrinkage would attend other asset values. Sound management in this respect would make for greater long-run stability, in dividend disbursements and market prices, and would reduce the rigidities in corporate financial plans which have been cited as social perils. For this objective in stabilization the writer doubts that there is any substitute for sound private management as an essential component of a soundly functioning capitalistic system.

The benefits of surplus policy supported here are not merely private or corporate. A reasonable buffer in corporate surplus, carefully administered as to its liquidity, provides a more even cash income stream and thus modifies stock price fluctuations which invariably occasion misfortune and inequity. But stabilization and srrengthening of stock equities augments the security behind corporate creditors' claims. In view of the widespread importance of corporate obligations as eligible trust fund investments, the problem of stabilization of stock equities is of far-reaching significance in the financial structure of society. Stabilization and simplification of capital equities, through judicious surplus policy, may even effect a more stable demand for the service of labor by providing flexibility in corporate financial plans.

These comments are not intended as an endorsement of monopoly. Monopoly and monopolistic competition present a challenging social problem. But it is the writer's conviction that retention of corporate earnings falls substantially short of a high road to monopoly. Surplus, through retention of earnings, is merely one source of corporate capital, and may or may not serve as a means of expanding a firm's assets. As a means of combatting risk, surplus retention is not a long-run expansion vehicle, since the reserves of excess profits established in prosperous years are apt to be wiped out by depression losses. As a source of funds for debt retirement, retained earnings are not properly an expansion or monopoly device; rather, they serve here to remove fixed claims and risk in financial structures and thus avert perils for which monopolistic or oligopolistic enterprises have received unfavorable criticism. Where retained earnings serve as a corporate-expansion method, they may support competition—especially by enabling small firms to compete more effectively. In some cases expansion by this means does augment monopolistic tendencies; and corporate surplus policy is a possible, though not a necessary, function or correlative of monopoly. But to close retention of earnings as one possible tributary to monopoly would be to invite the use of more rapid and hazardous tributaries to the same main stream. The contention that all corporate earnings should be disbursed as dividends and expansion accomplished by security sales rests on the assumption that the so-called open capital market should be "the test" for corporate accretion. But price behavior in the capital market disqualifies it as an acceptable, final barometer of justifiable financing. Mal-

distribution of corporate assets appears to have been confused at times with surplus accumulation; the two are different.

Overexpansion of corporate assets and consequent monopolistic tendency remain a problem in the policing of the economic system. But most students agree that the policing of the system should be in the public interest. From the standpoint of its primary financial functions, retention of corporate earnings has fundamental merit, privately and socially.

THE PROFESSION OF ACCOUNTANCY IN ENGLAND: THE PUBLIC, THE GOVERNMENT, AND THE PROFESSION

MARY E. MURPHY

THE ENGLISH accountant is called upon to maintain during his professional career two sets of relationships. First, are those relationships which are concerned with his immediate client with whom he comes in direct contact and by whom he is hired. Such relationships are based upon contract and must consider the statutory provisions which exist in reference to the audit. Second, there are intangible relationships which involve indirect clients, those individuals whose presence is not disclosed to the auditor when he is preparing his statements and reports but of whose identity, at least as members of a class, he is aware. Direct clients include sole traders, partnerships and limited companies as well as all types of organizations which according to English Law must submit their accounts to independent examination by auditors. Indirect clients encompass a much wider range of individuals as they will include readers of financial statements and reports, potential investors, bankers, creditors, the public and the Government—in fact, all who place reliance upon the data furnished by the auditor must be considered to come under this classification. In England where the auditor is appointed by the shareholders he considers them his direct clients. The wider the circulation of his reports, the wider becomes his responsibility toward their readers.

The public increasingly depends upon the data which result from company audits appearing in verbatim press comments on company meetings. If the investor were assiduously and competently to follow published accounting data of companies offering their securities for sale he would have a fund of information upon which to base his investment choice. It is interesting to note the criticisms of the accounting profession made by the press in England. The following are representative:[1]

1. The idiom employed in the accountant's certificate is too subtle for the average shareholder.
2. There is lack of information furnished by auditors.
3. When reservations are made in certificates too much is left to readers' inferences.
4. Accountants do not sufficiently warn shareholders.
5. The valuation of fixed assets is frequently not given.
6. Goodwill and similar accounts are generally disliked.
7. The valuation of shares of associated companies is questioned.

[1] Nelson, C. H., "The Accountant's Duties to the Press," *Incorporated Accountants Journal*, Oct. 1929, pp. 30–37.

8. Omnibus items in balance sheets and profit-and-loss accounts are considered a bad practice.
9. Reserves shown as liabilities is a questionable practice.
10. Over and under valuations are questioned.
11. The accountant's certificate on the prospectus does not contain sufficient information.

THIRD PARTIES

English accountants are not legally liable to third parties who may read their statements and suffer damage unless fraud can be proved against them. Third parties may be misled by the auditor's statements or reports and may suffer loss through his negligence, but if there is an absence of fraud there is no legal liability assignable to him. If auditors were made responsible to third parties the cost of auditing would have to be increased to permit them to make an examination sufficiently complete to cover all business transactions and to render them responsible for all the accounting details of the firm under audit. The legal definition of the lack of responsibility owed to third parties does not confine the English auditor to those limits for his moral thinking. He may not know that his statements are to be used by third parties but he must always consider that under modern conditions his data receive wide circulation and are the bases of many contracts made by other individuals. Certainly there is a stronger case for his acceptance of moral responsibility when he knows that his client intends to have additional copies made of his statements for the use of third parties. In such instances the auditor must constantly consider his moral obligation to third parties and insist upon clarity in his statements.[2] If he exercises professional skill and takes every reasonable precaution in examining the accounts he cannot as a whole be found guilty of negligence from the legal point of view. The accountant's responsibility to his client should be based upon the legal definition of his duties and responsibilities. His responsibility to third parties, wherever and whomever they may be, must be based upon his moral recognition of his obligations, obligations which in England are not recognized by law.

Legal privity of contract must be proved in England in order for there to be legal responsibility owed and legal recovery allowed for damages caused by reliance on the information supplied by the accountant. This privity of contract is present only when the third party is in effect, if not in name, one of the parties to the contract or at least occupies the role of beneficiary or *cestui que* trust under the contract. Therefore, from the legal viewpoint if the auditor's certificate or report is relied upon by the general public there can be no privity of contract running between the auditor and the public, or any member of it, unless the auditor accepts public responsibility through statements in his certificate. Even though the preparation of his statements be negligent and though they receive wide circulation through the medium of the press he is not legally liable for negligence although he would be liable if fraud could be proved against him. The jury hearing the case would have to decide whether the statements of the auditor indicated negligence on his part or fraud. Most English accountants would consider this legal definition of their responsibility to third parties to be much narrower than the moral definition of their obligation to these parties. The professional ethics of auditors are always in advance of their legal obligations and society relies upon the personal standards of practitioners. The English accountant, therefore, conducts his examination so that it may satisfy legal requirements. In addition, he approaches his work with complete and wholehearted

[2] Williams, R. G., *Elements of Auditing*, London, Gregg Co., 1934, pp. 194–204.

acceptance of moral responsibility to all individuals who may rely on his statements.

PROSPECTUSES

Under the Companies Act, 1929, the auditor must furnish for the prospectus a report covering the profits of each of the three financial years preceding its issue, the rates of dividends paid on each class of shares in each of those years and the classes of shares on which they have been paid as well as those classes of shares on which no dividends have been paid.[3] In addition, the accountants who are named in the prospectus must report upon the profits for each of the three precedings years of any business which is to be purchased out of the proceeds of the issue. When a statement in lieu of prospectus is made if a business is to be acquired the statement will include the amount, as certified by persons by whom the accounts of the company have been audited, of the net profits in respect of each of the three financial years. The Companies Act does not specify the form and content of the report which the accountant must make. Invariably the report concisely states the profits earned, and forms with the other data contained in the prospectus, including usually a statement of the net assets supplied by the accountant, the basic information for the potential investor. The accountant must of necessity draw up a report which will enable the investor to ascertain the possible future of the company selected for his investment.

The responsibility of the auditor for data he supplies for the prospectuses is restricted to those individuals who were the original allottees of shares and who were induced to buy because of the prospectus. He has no legal liability for negligence in regard to the prospectus under existing conditions. It has been urged that as in the event of fraud the auditor is liable at common law for damages suffered by the investor, his liability should be extended by statutory enactment to cover negligence resulting in loss to those, who as a result of the prospectus, subscribe to the issue. Under the present state of the law no person who buys or subscribes to shares on the basis of accounts or statements of the auditor can sue unless he undertakes to prove that there was fraud connected with the prospectus. The complete extension of the law would allow the investor to recover even if he had never seen the prospectus. Possibly English Law should be amended to make all persons named in the prospectus liable to damages to all persons who rely on its untrue statements. The liable persons would include bankers and brokers as well as accountants. The *Economist* recently has stated that instead of demanding higher standards for the prospectuses it might be better to reform the public taste rather than the statute law. Today in England investors are urged not to subscribe to an issue that does not name reputable accountants, and to ascertain that the subscriptions are sent to the larger banks as this indicates that the banks have sponsored the issue although they have no legal responsibility connected with it.

Unfortunately the listing on the London Stock Exchange is not given until after the allotment of shares has been made so many investors prefer not to act upon the prospectus but to wait until market trading indicates the true value of the shares. The large banks do not "father" issues even though their names are stated on the prospectuses for them. They only ascertain that the legal requirements regarding the issue are met and that the issue on its face is respectable. It has been suggested that banks should not appear to sponsor issues and that issuing units should be required to assume this obligation.[4] The legal liabil-

[3] Sections 34–38 of the Companies Act 1929 cover prospectuses.

[4] Macmillan, H. P., Chairman, Committee on Finance and Industry, Report, 1931, Cmd. 3897, Eng. Treasury, pp. 161–174.

ity of banks is much the same as the legal liability of accountants, the latter's liability being based upon his certificate. Accountants' moral responsibility is certainly greater than their legal obligation in England for the law offers the investor little redress in case of loss resulting from inaccuracies in prospectuses.

STOCK EXCHANGES

The London Stock Exchange is not operated under charter; it is felt that only in this way is complete freedom from government restriction possible. The reliance for its discipline solely upon the self-government of its members illustrates the theory of laissez-faire applying in business generally today in England. The Listing Committee of the Exchange requires approximately the same amount of balance-sheet and profit-and-loss data as is required by the Government; such information is generally limited and not uniform in type and amount. At the end of each accounting period, listed companies must submit duplicate copies of the statements required by the Companies Act 1929—which means a balance sheet, such as is circulated to shareholders, and a profit-and-loss account which has been laid by the auditor before the annual meeting. As has already been stated there is no legal requirement for holding companies to issue consolidated statements. The London Stock Exchange requires that all companies admitted in the future to listing must file a consolidated balance sheet, but it does not demand a consolidated profit-and-loss statement; these provisions do not apply to companies whose issues are already quoted on the Exchange or to units below the first degree. In all other instances the parent company is required to state the fact but not the detail of subsidiary companies' losses. Under the date of February 20, 1939 the Committee for General Purposes of the London Stock Exchange issued a letter stating that it will require good reason to be shown in the future before granting permission to deal in the stocks or shares of any holding company which does not publish consolidated statements.[5] Such a step may result in the building up of experience which can later be used by Parliament if the existing Companies Act is revised. Many individuals own investments in holding companies, and the increase in such holdings has been so large that there has been a change in opinion of the Exchange if not of the legal requirements for holding company statements. This move by the Stock Exchange will undoubtedly present problems to the accounting profession which must of necessity refine its holding company techniques and attack the problem of the wording of the accountant's report.[6]

The London Stock Exchange does not vouch for the soundness of the issues listed but does ascertain that the Companies Act is followed relative to legal requirements.[7] A Royal Commission examined the London Stock Exchange in 1877 and admitted that a somewhat fuller investigation than that made by the Listing Committee regularly might be made but it held the view that while it was the duty of the Committee to find whether a security should be quoted on the Exchange it was not its duty to place on it the stamp of a desirable or an undesirable investment. This philosophy still underlies the listing of securities on the London Exchange.

In England the responsibility of accountants in relation to security issues is limited to the preparation of necessary data to be submitted to the Listing Committee of the Exchange by the issuing company. As prospectuses must be prepared for all public offerings of issues in accordance with a prescribed legislative form to be filed at Somerset House and with the

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[5] Parkinson, Hargreaves, "Disclosure in Published Accounts," *Accountant*, April 15, 1939, pp. 502–506.

[6] "Stock Exchange Letter," *Accountant*, Feb. 25, 1939, pp. 246–247.

[7] Killik, Sir Stephen, *The Work of the Stock Exchange*, London, Committee of Stock Exchange, 1934.

Exchange, the accountant has an important task to perform in this connection. To those issues which are introduced to the public through the "granting of permission to deal by any recognized Stock Exchange in Great Britain" the statutory prospectus and registration provisions do not apply and no prospectus need be compiled, distributed or filed. In such a case the Committee of the Stock Exchange rather than a governmental agency assumes responsibility for the listing. There appears to be a distinct feeling in England that listing requirements of the Exchange based on the government's regulations as to accounting procedures should be followed by the profession rather than for the profession to urge amendments or modifications in existing legal or listing requirements. The application of this philosophy appears to work no great hardship on investors. Naturally there are losses and failures in English brokerage firms but the effectiveness of the work of the listing Committee of the London Stock Exchange and the English accounting profession is clearly shown by the small losses occasioned society. Mr. Walter Holman in his 1939 presidential address before the Society of Incorporated Accountants drew attention to the meetings which had been held during the year of the General Purposes Committee of the London Stock Exchange and the Institute and his Society, but Mr. C. J. G. Palmer in his 1939 address as president of the Institute deplored the unwillingness of the Committees of the London and the Provincial Stock Exchanges to ask accountants to elucidate points arising on prospectuses.

An interesting case involving a prospectus was that of James and Shakspeare, Ltd., published in the English press on September 5, 1934. Pepper commitments for the future were not disclosed by the books; the court held that if they had been incurred in the usual routine of business they did not need to be mentioned on the prospectus but if they were unusual in any way they should have been stated. No single statement in the prospectus was considered to be untrue, yet its general purpose was to deceive. Not only what is stated in an English prospectus or other accounting report is a matter of grave importance but the manner in which it is stated. The English accountant necessarily considers the implications issuing from what is stated in his reports as well as the purpose to which these reports are directed. Primarily and importantly he recognizes his responsibilities toward his immediate clients and to those individuals to whom his reports are directed. The wider the scope of his services to the public the wider becomes the scope of his obligations to the world. He cannot accept one phase of his activity without accepting the accompanying ever-widening and more complicated ramifications of responsibility.

THE GOVERNMENT

The Companies Act 1929 is the chief legislative measure affecting the maintenance and audit of accounts by all public and private companies operating under English Law. Section 123 deals with the necessary financial statements; Section 124 applies to requirements for the balance sheet, and there are no specific requirements as to the profit-and-loss account except that the total directors' fees, other than the salaries of managing directors, must be included in it. Sections 45, 46, 47 and 75 apply to items in the balance sheet; Section 128 relates to loans and remuneration to directors. Section 132 deals with the appointment of auditors. Section 133 lists the individuals who are disqualified from becoming company auditors, and Section 134 states their rights and duties. Sections 125–127 deal with holding company and subsidiary requirements. Banking and insurance companies, deposit, provident or

benefit societies come under Section 131. Assurance companies coming under the Companies Act 1909 are excluded under Section 131 of this Act. Such organizations as well as public utilities are required to present their accounts in forms prescribed by statute. Solicitors are now required to keep accounts which will reveal money received and disbursed for clients, and such cash must be maintained in a separate bank account.

Individual proprietorships or partnerships do not have accounts prescribed for their operations and the parties concerned have the right to inspect their accounts at any time they wish.[8] Section 274 of the Companies Act 1929 brought this Act in line with bankruptcy. The Bankruptcy Act of 1914 as amended in 1926, states that if proper books of account are not maintained for the two years preceding the bankruptcy this shall be considered a misdemeanor.[9] Most of the bankruptcies in England are administered by accountants in the role of trustees; in the case of receiverships accountants also are invariably selected as it is thought their experience fits them for the important position of receiver.

Close examination of English Company Law reveals that many restrictions are imposed upon the limited company but as to account maintenance the requirements are not numerous. The auditor's efficiency and high professional standards are relied upon to protect the public interest. Stanley Rowland has stated that the requirements of Section 134 (1) (b) of the Companies Act 1929 have formed part of the law in England for a long period of time and that they stress the auditor's characteristics of watchdog rather than those of the bloodhound. Since English business philosophy is nonrestrictive and individualistic it is unlikely that the existing Companies Act will be amended unless definite deficiencies in it and abuses under it become apparent. Amendments if enacted should be based on the following premises:[10]

1. There must be very little doubt as to what is required in order to comply with the law.
2. There must be little which is illogical or inconsistent in relation to the classes of items which must be and need not be disclosed.
3. There must be little embarrassment caused directors by enforcement.

There are many expressions of a more militant opinion relative to amendment of the Companies Act, especially that voiced by members of the Society of Incorporated Accountants and Auditors, but the general feeling in the profession is that amendment is not at this time desirable, that it is better not to include all company practices in law but to rely upon the ability and integrity of company directors and auditors. It does not seem probable, therefore, that such matters as requirements of the profit-and-loss account, and the holding and subsidiary company accounts and statements—which seem to demand immediate legislative action to bring English legal standards on a par with those maintained in other countries—will in the near future be subjects of legislative enactment. Nor does amendment of the auditing and accounting provisions of the present Act appear probable.

INVESTMENT TRUSTS

In England investment trusts come under the Companies Act 1929 with respect

[8] Rowland, Stanley W., *Accounting*, London, Thornton Butterworth, Ltd., 1936, pp. 215–221.

[9] The proper records are defined by law as: Such books or accounts as are necessary to exhibit or explain the transactions of the trader and the financial position in his trade or business, including a book or books containing entries from day to day in sufficient detail to enable the goods and the buyers and the sellers thereof to be identified.

[10] Cutforth, A. E., "The New Accountancy Requirements of the Companies Act 1929 in the Light of Experience," *Accountant*, July 7, 1934, pp. 13–23.

to provisions for audit and the publication of financial statements. English unit trusts, on the other hand, are not covered by the provisions of this Act. For such trusts there is no filing of data, as required of the limited company, and there is a lack of legal responsibility for statements printed in booklets inviting subscriptions. In December 1935 the Report of the Sub-Committee of the London Stock Exchange on Fixed Trusts was issued. It was suggested in this report that within 14 days of fixed dates specified in the trust deed the trustee should each year prepare a certified account covering the income distribution. This account should cover:

1. Full amount of all cash dividends and bonuses received and amount of tax deducted.
2. Similar information with regard to tax-free dividends.
3. Any other cash receipts which it is proposed to distribute showing whether capital or income.
4. All deductions or expenses or remuneration of trustee and managers.
5. Net amount distributed distinguishing between capital and income.
6. A statement of underlying securities and cash released in the half-year to the trustee and managers for their remuneration and/or a certificate from the trustee that an adequate amount was still on hand to cover future remuneration.

The Committee suggested any circular (which is considered to be a descriptive booklet) issued to the public should contain name and address of the accountant. It felt a further investigation of trusts should be made and on February 11, 1936 the Board of Trade announced a Departmental Committee would be formed to inquire into the subject of trusts. At that time there were 51 fixed and 16 flexible trusts in existence. The Report of the Committee was rendered in August 1936 and it suggested that full trust accounts and accounts of the management company should be filed and made available to unit holders. Directors of the management company and other interested persons and corporations were not to be qualified to act as auditors. The appointment of the auditor was to be subject to the approval of the trustee, and the trustee and majority of the holders of units (or sub-units) were to have the power to remove the auditor. A meeting of unit or sub-unit holders was to have the power to appoint the auditors. Management companies were to prepare balance sheets, profit-and-loss accounts, and separate accounts showing unit or sub-unit dealings for each trust. Among large items to be shown separately were reserves for remuneration and expenses during unexpired trust periods, expenses for advertising and publicity (as distinct from management expenses), amounts of agents' commissions on sales and repurchases, amounts realized by sales of units or sub-units, amounts separately added to prices of underlying securities on account of accrued dividends, service charges, etc. The trustee company was to prepare statements showing separately the constituent items in the amount distributable each half-year, distinguishing amounts in respect of capital, statements showing composition of funds held on behalf of the unit or sub-unit holders as regards capital and as regards income, and figures relating to transactions in investments and other assets and the income thereform. The Committee made provision for the accessibility of those documents to interested members of the public. These are the main accounting provisions suggested by the Committee; it is possible that they will at some time in the future be incorporated in legislation dealing with investment trust problems. The recently passed Prevention of Fraud (Investments) Act, which repeals Section 356 of the Companies Act 1929 and offers substitute provisions for it, attacks the problem of unit trusts by stating that they may become authorized unit

trusts by satisfying the Board of Trade that they comply with a statement of requirements. This Act contains provisions covering audit of unit trusts.

TAXATION

The English accountant's position in matters of taxation is a complicated one unless his instructions are restricted by his client. He must inform his client of requirements of tax laws and must take advantage of every point for him. At the same time he must consider his obligations to the taxing body, the Government, and the necessity for maintaining his own as well as his profession's reputation. Once the liability for tax in England is agreed upon it is the accountant's responsibility to utilize his powers of advocacy or negotiation to settle the liability for his client as favorably as he can.[11] Roger Carter speaking at the 56th annual meeting of the Institute of Chartered Accountants drew attention to the "gap-stopping" legislation contained in the Finance Act of 1936 and to the widespread evasion of tax accomplished by means of foreign companies and family maintenance agreements.[12] While it is necessary for the profession to inform their clients of such devices so that they will not be at a disadvantage still the profession did much to encourage the passage of this act by Parliament. The Finance Act of 1938 continues this philosophy. A. E. Cutforth declared in his 1934 presidential address before the Institute that the accountant should utilize all means at his command to minimize the liability for his client for taxes during the client's lifetime and the liability of his estate after his death. A wealth of material is contained in tax returns which can be utilized by the economist.[13]

The English attacked their tax situation by appointing a Royal Commission in 1919 to make an investigation and it was decided then that the interests of the national welfare were best served by encouraging limited companies to build up reserves, even at the possible risk of losing some revenue in surtaxes. There is no undistributed profits tax in existence in England; the only regulatory measure adopted has been a restriction regarding accumulations by personal holding companies. Even with these restrictions the question of what constitutes reasonable accumulation is decided by a board of referees.[14] A company may, if it desires, submit its accounts in advance of a dividend and secure a clearance on reasonableness of distribution. In England the tax inspector does not have the legal right to examine the books of the taxpayer but he may request statements of profit and loss and other information prepared by accountants. The fact that an independent accountant has examined the statements carries much weight with English tax authorities. The statements and other pertinent facts are discussed by the inspector of taxes and the company submitting them in order to arrive at the taxable income. The question is not whether the accounts are correct but rather what

[11] Meyers, John, "A Century of Professional Accountancy," *Accountant*, Feb. 24, 1934, pp. 167–169.

[12] Report of Income Tax Codification Committee, 1936, Cmd. 5131, p. 13: "Expedients have been devised for stopping each loop-hole as it was discovered and removing each genuine grievance as it was brought to light, until the fabric has been overlaid with incongruous patches."

[13] Stamp, Sir Josiah (now Lord), *Studies in Current Problems in Finance and Government*, London, F. S. King and Sons, Ltd., 1924, pp. 3–25: "English accounting practice has been developing for many years but it has not made any substantial contribution to economic science over its own field of the analysis of the results of industry although it has practically a monopoly grip of the required data. Accountants have the figures; other people cannot use them and if accountants will not, then we get nothing; economics continues its abstract declarations and business blunders on by individual instinct."

[14] The law states that: The Commissioners shall have regard not only to the current requirements of the company's business but also to such other requirements as may be necessary or advisable for the maintenance and development of that business.

adjustments may be accepted by both parties in arriving at a tax figure at an early date suitable and acceptable to them. Much trust reposes in the accountant in tax matters in England, as his statements are accepted without question as the basis upon which negotiation takes place. Few appeals occur as the inspectors are well trained men whose policy it is to arrive at an equitable tax figure.

The first machinery to administer taxation in England was set up in 1842. The present income tax in England taxes annual business profits but does not define either annual or profit; this situation has led to a great deal of confusion in the preparation of accounts. Stanley Rowland has stated that the main difficulties connected with the English Income Tax arise from these causes:

1. Taxation proceeds by fiscal years which are hardly ever co-terminous with domestic accounting years.
2. The tax assessed and paid in a fiscal year and expressed for that fiscal year springs out of the profits of past accounting years.
3. When profits are ascertained and (perhaps) distributed the rate of tax which will ultimately be applied thereto is nearly always unknown.
4. The principles of collection at the source (if no other) imports very material differences between the amount of assessment later associated with it.
5. Under the statutory rule 21 where distributions to external parties (for example, debenture holders but not shareholders) in a fiscal year exceed the assessment levied in that fiscal year, tax on the excess must be handed over to the Treasury.

A recent tax bill, which operates from April 1, 1940, when the fiscal year began, raises the excess profits tax to 100% on profits over a fixed limit on all concerns whether or not engaged in war production or trades or business. Reliance is placed by the government in practitioners to ascertain that this measure reaches maximum application.

GENERAL GOVERNMENTAL REGULATION

The general philosophy in England is that in most instances more is accomplished by "advisement" of companies than through the enactment of laws and the issuance of edicts. This policy is well illustrated by Sir John Simon's recent unofficial ban on the buying of U. S. Securities by the English and the immediate concurrence of the English financial world with his attitude. The Englishman has a personal code of ethics which he enforces quite irrespective of the law; the law is utilized only to stifle the most blatant and unethical practices. The English business man is first and foremost a gentleman, and secondly a business man. The use of the boycott has proved to be more effective in many instances than the imposition of legal measures.

The Companies Act of 1929 does not contain stringent requirements on accounting methods and liability of directors. It does not require that auditors make an annual physical count of inventory; it does not hold them liable for the ascertainment of the earnings figure and does not require that profits from trading, dividends and non-recurring income be separated; it does not require that the amount or the method of depreciation be indicated; it does not require detailed balance sheets stating the method of determining the amounts of material contracts, contingent liabilities and underwriting details for prospectus requirements. The Englishman is at heart skeptical regarding the importance and effectiveness of written laws. He does not believe that laws make people honest. Instead he feels it is better to achieve ethical conduct through informally imposed rules of conduct than to rely on rigid statutes. To be specific, the accounting profession firmly believes that if the law tried to state exactly what should and should not be included in the audit the result would be that directors and auditors would rely upon the

law, losing their independence of judgment and looking upon it as a completely inelastic standard which they must at all times follow.[15]

The members of the English profession in articles and speeches constantly refer to the use of persuasion to achieve the betterment of accounting techniques and standards. Such persuasion is not required by law of the auditor; it must be envisaged by him through his close contact with the affairs of a specific business as advisable and efficacious. The Englishman knows that the courts and the Government rely on skill and integrity of accountants. For example, many technical terms have arisen through the combined efforts of the legal and the accounting professions and the reliance of the Government on the profession is well illustrated by any tax case, the accountants and tax inspectors meeting and settling differences by means of amicable conversation. The shareholder, the banker, the Government and the man in the street all know that they can depend completely upon the English auditor and his audit, upon his knowledge of the law and his unremitting effort to urge his clients to go beyond it in formulating their principles for accounts and statements.

PROFESSIONAL RESPONSE TO THE WAR

The English profession has had to cope with a flood of emergency statutes, orders, rules and regulations.[16] Complicated accounting problems proposed by these measures, by the Chancellor of the Exchequer, the Emergency Power (Defense) Bill 1939, and the Finance Act, 1939, have been attacked with customary fortitude and skill. Under the Prices and Goods Act, clients have requested accountants' reports and certificates to substantiate increases in their selling prices. Practitioners have certified claims to the government for expenditures made under Civil Defense and Ministry Supply Acts.

In furnishing cost reports and certificates accountants have endeavored to represent fairly both the government and clients. In spite of depleted staffs, statutory audits have proceeded with customary speed except in a few instances where assets held abroad have necessitated special verification.

There are approximately 9,000 Institute names on the Voluntary Register established by the profession soon after the outbreak of the war. Of this number, 3,000 are capable of undertaking whole time national service. Many accountants are holding responsible positions in governmental bureaus and in the various War Ministries. An Emergency Committee of the Institute has recently been appointed with authority to act in respect of matters of emergency which may arise during the duration of the war. In every aspect of its work, the accounting profession in England today is responding to the government's enlarging demands upon its responsible and skilled services.

THE PROFESSION

The economic, social, and political climate of England dictates the mode and trend of the accounting profession. The profession's ethics are written by its societies but they are developed by the practice of its members.[17] This individual de-

[15] Brooks, Collin, "Clashes of Duty in Accountancy and Business," *Accountant*, Nov. 16, 1938, pp. 673–678: "In all departments of life the trend is distinctly toward more and more rigid legislation. In so far as we as citizens can influence that trend I feel that the very knowledge that so many duty dilemmas exist should cause us to be very chary in urging or supporting reforms in Company Law which hamper our individual choice of conduct when the nice questions arise."

[16] For discussion of various emergency measures and their effect upon practice, see the author's article in *Journal of Accountancy*, July, 1940, pp. 9–12, "The British Accountancy Profession and the War."

[17] Waterhouse, Sir Nicholas, "Matters Affecting the Profession in Great Britain and Ireland," *Accountant*, Oct. 15, 1938, pp. 529–535: "There are no internal regu-

velopment is the resultant of two forces: the standards of the accountant which are evolved by contact with practical situations, and his response to the impact of society's demands upon him. The accountant has been aptly called the "medical consultant of industry" and in England he is frequently placed on company boards of directors, in many cases as chairman, and on governmental commissions and committees. His name is often discovered in the King's Birthday Honors List, and as already stated, accountancy is recognized as one of England's leading professions.[18] The recent decision of the House of Lords in *Carruth v Imperial Chemical Industries Ltd.*, indicated the weight the court gives to the accountant's opinions.[19]

It is interesting to note that as early as 1820 Sir Walter Scott, in discussing careers with his nephew, suggested accountancy, considering it one of the outstanding professions at that time.[20] Under modern conditions the profession maintains its standards and continues to improve its techniques. Certificates to practice are granted by the societies themselves and not by the State. The annual yearbooks of the various societies state their aims and objectives.[21]

Under modern conditions no individual in England is more able to advise on matters of an accounting and business nature, than the auditor who is trained in theoretical matters and has a wide background of experience upon which to base his decisions. Inevitably statutory enactments of the future will increase the scope of the accountant's work and consequently his responsibility. It would probably be more satisfactory if that portion of his work which is construed as applying to the discovery of defalcations were set apart as a separate function from the regular statutory audit.[22] The system of internal check in force would then be the responsibility of the directors and not of the accountant. There is a decided feeling in the English profession that the responsibility of the auditor should not be unduly extended. The Derry and Peak Case is referred to as precedent for such a thought as its ruling embraces the premises: that the statement made by the accountant must be proved untrue in fact, that the accountant must

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lations affecting the accounting profession in Great Britain as a whole. The profession is not an organized body and there is no single authority which has control over it, the only internal regulations affecting professional accountants are those made by the various institutes and societies of which the large majority of practising accountants are members. Some practising accountants are not members of any organization and are subject to no professional code except general law and their own code."

[18] Carr-Saunders, A. M., and Wilson, P. A., *The Professions*, Oxford, Clarendon Press, 1933, pp. 208–227.

[19] The judge in this case stated: "On consideration it appeared to me that this item, large as it was, ought not finally to weight in the balance against the final, independent, and highly instructured opinions of the company's accountants, that the scheme was, in their judgment, entirely fair to the deferred shareholders. . . . Their testimony, entirely disinterested, I feel I might properly accept."

[20] Lalient, *Life of Sir Walter Scott*, Edinburgh, 1839, Vol. 6, p. 223.

[21] The Royal Charter of the Institute states that the societies which were amalgamated as the Institute (namely, the Institute of Accountants and the Society of Accountants in England) were not established for the "purposes of gain nor [illegible] the members thereof desire or seek any pecuniary gain from their membership but the societies aim at the elevation of the profession of public accountants as a whole and the promotion of their efficiency and usefulness by compelling the observance of strict rules of conduct as a condition of membership and by setting up a high standard of professional and general education and knowledge and otherwise."

The Yearbook of the Incorporated Accountants for 1939 states the objects to include: "To provide a central organization for accountants and auditors, both men and women, and generally to do all such things as from time to time may be necessary to elevate the status, and to procure the advancement of the interests of the profession; to provide for the better definition and protection of the profession by a system of examinations and the issue of certificates; to promote and foster in commercial circles a higher sense of the importance of systematic and correct accounts and to encourage a greater degree of efficiency in those engaged in bookkeeping; to provide opportunity for intercourse amongst the members, and to give facilities for the reading of papers, the delivering of lectures, and for the acquisition and dissemination by other means of useful information connected with the profession and to encourage improved methods of bookkeeping; to watch over, promote and protect the mutual interests of its members."

[22] Jones, E. F., "The Professional Accountant," *Accountant*, Oct. 20, 1934, pp. 548–554.

have known that the statement was untrue, that it must have been made with the intent that the plaintiff would act upon it, that he did act in reliance on it, and that he suffered damage in order for there to be recovery from the accountant. Yet Stanley Rowland has drawn attention to the fact that in recent English court decisions the trend has been to lengthen the chain of consequences for which a negligent accountant can be held responsible. Reference is made to the case of *Armitage v Brewer and Knott* in which the judge stated:

It is one of the objects of the audit to get rid of a fraudulent servant and it is the duty of an auditor to be suspicious, since if everyone were honest there would be no need to employ an auditor at all.

This contrasts very sharply with the legal theory that has underlain English practice: that the auditor is a watch dog, not a blood hound. If this decision were followed by English courts in the future much more legal responsibility would attach to the auditor than has previously been his. As early as 1899 the accounting profession in England was urged to prepare itself to accept added responsibility in order that its usefulness to society might be increased.[23] And in 1934 Sir Nicholas Waterhouse declared that if accountants were careful of their express and implied contracts, if they exercised reasonable skill in their activities and if they resisted unjust claims made upon them in the courts they would fulfill their obligations to society.[24]

The great fear of the accountant is the loss of his reputation. By satisfying his obligations to his client and to the public to the utmost of his abiilty and training he builds up and maintains his good name. His moral responsibility is based upon his legal responsibility; he must never be found negligent in performing his duties for his client. He symbolizes the best practice of his profession, and at all times in his career he remembers that he is the exemplification not only of his own ethical standards but of those of his profession.[25] Each profession necessarily assumes responsibility for the activities and skill of its members and prohibits such activities as will bring disrepute to the profession itself.[26] The dual responsibility—that of the profession for its members' conduct and that of the members for the profession's standards—is firmly ingrained in the mind of all English accountants. It is frequently difficult to maintain the "long view" of an action; what is profitable for the practitioner individually may result in bringing discredit to the profession itself. The profession therefore rises or falls because of the morals or lack of morals on the part of its members.

English laws do not set the limits of the auditor's moral responsibility nor do they indicate the individuals to whom he must recognize obligations.[27] Such limitations

[23] Woolley, Charles, "Duties of Auditors," *Accountant*, July 29, 1899, pp. 822–823.

[24] Waterhouse, Sir Nicholas, "Liability of Auditors," *Accountant*, Jan. 27, 1934, pp. 121–127.

[25] Keens, Thomas, "Accountancy, The Etiquette of the Profession," *Incorporated Accountants' Journal*, April 1933, pp. 47–51, names four tests to be made by each practitioner to measure his activities and to limit them ethically: 1. Is the proposed incident likely to bring the slightest discredit to or criticism of the practitioner on the part of other members of the profession? 2. Is it likely to prejudice the client? 3. Will it injure society? 4. Will it be prejudicial to fellow practitioners?

[26] Tawney, R. H., *The Acquisitive Society*, London, G. Bell and Sons, 1921, pp. 106–116.

[27] Jeal, E. J., "The Learned Judges and the Auditors," *Accountant*, June 10, 1939, pp. 777–783: The statutory position of the auditor derives from the statutes that are contained in the Companies Acts and in other Acts, case law and professional and commercial usage. The three types of proceedings which may occur are ordinary civil actions under common law or statutes governing the auditor's appointment, actions against him for misdemeanors and misfeasances with Sections 274 and 276 and 362 of the Companies Act 1929 applying, and criminal proceedings where the auditor is guilty of misconduct under Section 84 of the Larceny Act 1861. English judges have, as a whole, shown disinclination to generalize and have paid close attention to the particular circumstances pertaining to each case, have emphasized the intention of the law in contradistinction to

are envisaged by the profession and by each accountant in his consideration of the engagement at hand and its particular circumstances. Only in this way does the profession become a leader in the field of rapidly evolving accounting practices; only in this way does it indicate the need for legislation and the necessity for revision of directorial and company practices. For instance, English accountants might organize a program of attack upon the secrecy which shrouds much of the business activity of their country, and urge publication of data which exceeds the legal minimum. But before they can do this they must decide what information should be revealed by company accounts and financial statements, and the principles upon which they should be based.[28] Codes of ethics maintained by the English profession are vastly important as they indicate by written word and standards to be adhered to by all practitioners.[29] A small book *The Etiquette of the Accountancy Profession*, published in 1927 by a Chartered Accountant, states the outstanding principles of ethics but beyond its tenets the individual must chart for himself a course to be followed.

The Accounting Research Association formed several years ago and composed of economists and accountants has for objectives the promotion of research in the history and development of accounting, the discovery in particular of how economic, social and legal changes have affected the development of the methods of accounting, the examination of the present position of accounting theory, and the examination of the present position of accounting theory and practice. Such research can be utilized by the Government when new legislation is proposed or the present Companies Act is amended. And it can be used by business managements in comparing accounting practices and financial statements against the ideals evolved by the profession itself. Just how far the mores of the English profession have diverged from those of other countries should be revealed by this research. A more recent development is the formation of the Accountants' Group with membership not confined to any particular body or bodies but open to all interested individuals with the hope that it will produce constructive approaches and reforms and avoid completely destructive criticism of problems of mutual interest.[30] English accountants are exhibiting their progressiveness by carving out for themselves and for their profession standards which embrace formulated legal statements of responsibility and individual enlargement of them and by recognizing the problems which apply to their profession and to the business world in general. One of the greatest tributes paid to the English accountant, who is a member of a recognized society, is that his reports and statements are questioned by no one in the usual

its strict wording, and have attached great importance to common usages in accounting, auditing and business.

[28] De Paula, F. R. M., *Principles of Auditing*, London, Sir Isaac Pitman and Sons, 1936, pp. 201–204.

[29] The April 1937 resolution of the Institute specifies that: "Where a change of auditors of a company is proposed it shall be the duty of any members of the Institute before acceptance of the nomination for election to communicate with the existing auditors with a view to ascertaining the circumstances in which a change of auditors is proposed."

[30] An article in the *Accountant*, March 4, 1939, p. 292, states the aims and objects to include: 1. To examine and ascertain the relations of the profession to society and to consider how best the accountant's specialized training may be utilized to further the betterment of the community as a whole; 2. To discuss and consider problems concerning the accountant and his work; 3. a, To investigate the training of accountants and educational facilities and methods, with particular reference to possible amendments of the present system of articles; b, To consider plans for the improvement of the status of the accountant and in particular schemes of registration for the purpose of obtaining the "closed door" principles in the profession; 4. To investigate and promote where necessary desirable legislation; 5. To determine the real functions of accountants and to utilize methods for their clarification in the public and professional minds; 5. To provide a forum for exchange of views, lectures, reading of papers and discussion culminating in direct action arising therefrom and from all or any of the above objects.

course of events, not even by the Government, and are utilized as the basis for taxation, promotion of companies, sales of securities, and negotiations. The discipline of members by professional organizations has done much to strengthen and maintain the written codes of ethics. In very few cases must the law be appealed to in order that the members of the profession may be disciplined or punished for infraction of legal and professional standards.

In England unless legal regulation can be proved absolutely necessary it is avoided; rather governmental committees are set up to gather evidence and to pass on matters which are under consideration with action being deferred. Dependence is placed upon the personal integrity of the practitioner rather than upon the written word of the law.[31] More and more attention is devoted by the accounting profession to the larger aspects of its work and to the ramifications touching upon economics.[32] The complications resulting from the accountant's position as he stands between his client and the world are increasingly apparent.[33] He can aid in the establishment of sounder business principles; he can promote the establishment and maintenance of ever higher standards of accounting practice; he can attack the problem of the formulation of acceptable techniques and principles for his profession. The English accountant is increasingly aware both of his strength and his limitations. He desires to strengthen his position through increase of his independence.[34]

Throughout all legislative measures and throughout the activities of professional societies runs dependence upon the accountant's ability and his personal integrity. The maintenance of personal reputations by the members of the profession is the motivating consideration. As this maintenance is continuous and if morals are con-

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[31] This belief is expressed in the 1934 presidential address of A. E. Cutforth before the Institute in which he said: "It is better that any desirable reforms should come about voluntarily by an improvement in general practice than that an attempt should be made to enforce them by legislation. . . . A practical difficulty in regard to legislation is that compulsion is enforced in all cases irrespective of circumstances; one effect of legislation would be to free auditors from the responsibility of having to make a decision as to whether accounts approached an adequate disclosure of the position. . . . The effect of limiting our discretionary powers may be calculated to undermine our status. . . . We shall endeavor to preserve our unbiased attitude and to assess impartially the respective rights and responsibilities of auditors, directors, the public and the State."

[32] Rowland, Stanley W., "Some Modern Difficulties in the Measurement of Profits," in *Some Modern Business Problems*, edited by Arnold Plant, London, Longmans Green and Co., 1936, pp. 249–274: "If the lawyer is the professional accountant's grandfather, the economist is a distant relative, who now appears to be wishful of marrying into the family; indeed he is already on walking-out terms with many of the most ornamental and promising members of the new generation."

[33] Greenwood, Thomas, *Shareholders and Auditors*, London, Gee and Co., 1933, pp. 13–14: "Theoretically the auditor is completely independent of the directors. He has been elected by a vote of the shareholders . . . to safeguard their interests. . . . No person of affairs, however, is deceived by the fiction that auditors are appointed by the shareholders. Everybody knows that in most cases it is the directors themselves who, in one way or another, secure the auditor's appointment and decide how much he shall be paid for his work. That is to say, the watch-dog has to look for his food to the person whose actions he is supposed to be watching."

Kissan, E. D., and Danielson, L., *Investments in Stocks and Shares*, London, Sir Isaac Pitman and Sons, Ltd., 1933, p. 159: "It is seldom that accountants do not in fact owe their appointment to directors and not to shareholders and only rarely do shareholders appoint accountants whose appointment is opposed by the directors. For this reason it is often urged that some new method of selecting accountants would be beneficial even that a government department like the Board of Trade should appoint them."

Parkinson, Hargreaves, *Scientific Investment*, London, Sir Isaac Pitman and Sons, Ltd., 1933, p. 154 "Whereas the auditor in theory is the shareholders' watchdog, in practice his function has been whittled down to that of a glorified checking clerk. If he makes himself a nuisance, his connection with the company may be short. . . . If the shareholders' watchdog is to be really effective it is urged that he must be on the board and must enjoy the dignity and security of tenure which such a position implies."

[34] Carr-Saunders, A. M. and Wilson, P. A., *The Professions*, Oxford, Clarendon Press, 1933, pp. 222–223: "We are strongly of the opinion that if the public wants fuller publicity of trading results it should relieve the author of all uncertainty as to its desires by securing their enactment in legislative form."

Greenwood, Thomas, *Shareholders and Auditors*, London, Gee and Co., 1933, p. 15: "We want greater independence, in order that we may speak with greater insistence, and be relieved from the possibility of pressure from directors."

stantly elevated by practitioners the profession has little to fear in regard to publicriticism or the introduction of governcmental regulatory measures. It will survive and increase its usefulness to society by means of the efforts of individual accountants. The experiment in laissez-faire continues in England in business and it is reflected in the profession of accounting. It is generally felt that standardization if carried to an extreme would stultify individual initiative and would retard professional developments.[35] Rather it is believed that it is the obligation of the profession itself to set and maintain its standards, and to develop its procedures in response to business and social demands.[36] This results in elasticity for the profession.

The English profession recognizes the fact that a Companies Act exists which can be relied upon in accounting situations is both an advantage and a danger. It gives clarification to accounting requirements but directors tend to fall back upon it and to disclose only what is required by law.[37] The audit follows the legalistic pattern and it is the exception for directors to break the pattern and to go beyond the law in account formulation and disclosure of data.[38] That the law has not kept step with social and economic changes is evident; in many instances what is considered good accounting practice is far ahead of the wording of the statute.[39] The English audit is synthetic—that is it begins with original data and works forward to summarized results with emphasis placed upon checking, articled clerks being utilized for this work. Too frequently in the past the routine of the audit has absorbed the accountant's attention and little time has been devoted to the interpretation or comparison of completed data.[40] Infinite effort is spent by the audi-

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[35] Company Law Amendment Committee Report, 1926, Cmd. 2657: "The matter of accounts is one in which we are satisfied upon the evidence before us that within reasonable limits companies should be left a free hand. It would be a mistake in our view to attempt further to define the powers and duties of auditors." Moore, Kenneth and Michael, *Company Accounts and Balance Sheets*, London, Jordan and Sons, Ltd., 1931, pp. 96–103: "Legislature has always recognized that it would be impracticable to prescribe the exact form of published accounts to be adopted by the ordinary trading company and to define the amount of information to be given therein, having regard to the wholly differing circumstances of the innumerable businesses covered. In spite of the provisions of the Companies Act 1929, there is still a wide discretion left to directors as to the form of published accounts and the extent of information appearing therein."

[36] Rowland, Stanley W., "Experience, Research and Speculation in Accounting," *Accountant*, April 1, 1939, pp. 442–444: "The canons of accounting must ultimately persuade by their reasonablenesses the man in the office, the man in the board room, the man in the stock exchange, and finally the man (and the woman) in the third-class carriage who are the ultimate arbiters of human affairs."

[37] Carter, Roger N., "Response to Address of Welcome, American Institute of Accountants Anniversary Meeting," *Accountant*, Nov. 13, 1937, pp. 666–668: "We look to the Companies Act 1929 for our duties and however much further we may go on our own initiative it is that Act by which our certifications, etc., must be primarily governed."

[38] *Accountant*, April 16, 1932, pp. 509–511: "The root of the trouble is the poor standard of accounting so complacently practiced by innumerable boards of directors. It cannot be too clearly understood by the public that when the statutory form of report is signed without qualification by the accountant, the signature does not imply the accountant's approval of the relative accounts as representing the highest ethical and technical standard of accounting presentation. The responsibility for published accounts lies with the directors of the company concerned and so long as accounts comply with a minimum legal standard of disclosure the auditor has no official power whatever to interfere with the discretion of the board."

[39] Carr-Saunders, A. M. and Wilson, P. A., *The Professions*, Oxford, Clarendon Press, 1933, p. 221: "At the time when English Company Law assumed the form which, in essentials, it still retains, the typical company was a small concern, whose shareholders were drawn from a narrow circle. . . . It was assumed that they would be in a position to assure themselves of the business ability of those whom they elected as directors . . . consequently the auditor's certificate was directed primarily to the legal aspect of the company's finances. . . . In recent years the increasing size of the typical company, and the increasing application of accounting methods to trading operations have profoundly affected both the relations between the shareholders and the board, and the actual if not the legal relations between the board and the auditors. Nevertheless the law has remained in all respects unchanged."

[40] Rowland, S. W., *A Reconsideration of Auditing Methods*, London, Gee and Co., 1934, pp. 5–6: "It is not an unfair criticism to say that the general conception (the synthetic process) has resulted in emphasis being laid on arithmetical phenomena. The conception has colored legislation which governs us and it has determined the public estimate of our functions."

Withers, Hartley, *Investing Simplified*, London,

tor in ascertaining that each statement which he examines complies exactly with the law. Frequently insufficient attention is given to expanding the legal requirements for accounting data.[41]

The cultivation of an attitude of mind on the part of both company directors and auditors in England today is essential. And individual approaches to problems at hand based upon statutory requirements but considering the actual needs of shareholders and other individuals who may read and rely on statements is vitally necessary. The professional societies can throw their individual and combined weight for improvement in accounting techniques and procedures underlying statement presentation.[42] The English profession is endeavoring to develop a body of principles which can be considered to underlie the best practice; it wishes to formulate its views concerning necessary alterations in legal procedure before such changes are proposed. At all times English auditors seek to reveal as false the accusation made by Sir Mark Jenkinson that "backers of horses have better information available than speculators in shares" and prove the fact that this statement cannot be applied to shareholders of English public companies. They look back upon a long and worthy history of professional achievement and forward to a development of which they can be equally proud.

Thornton Butterworth Ltd., 1934, p. 64: "For years discussions, often conducted by and before Commissions and Committees of high authority, concerning improvements in the presentation of company accounts have been held, but the simple reform of making them show growth or decline by insisting in all cases on the publication of the corresponding figures for the previous period has been so obvious that it has never been thought worthy of adoption."

[41] "The Present Position and Responsibility of Accountants in Commerce," *Accountant*, July 15, 1933, pp. 82–84: "The fact has to be recognized that British auditing practice has been overlaid with a mass of legislative details. The statutes give the minimum degrees of disclosure to the public; auditors should see that these do not become the maximum."

[42] Minutes of Evidence, Departmental Committee on Registration of Accountants, 1930, p. 22: The weight of concerted action on the part of professional organizations is indicated by the fact that out of 5,500 companies with shares listed on the London Stock Exchange 90% were audited by firms with partners composed entirely of Chartered Accountants, 3% by firms composed entirely of Incorporated Accountants, and 3% by firms all the partners of which were either Chartered or Incorporated Accountants.

ELEMENTARY COURSES IN COST ACCOUNTING

S. Paul Garner

The problem of the content of the first course in cost accounting has been of recurring interest to instructors for the past twenty years. Several interesting articles have appeared in the Accounting Review from time to time, in which one or more of the various phases of the problem have been discussed.[1] In an attempt to obtain more recent prevailing opinions of cost instructors, the present writer had an opportunity in another study[2] to conduct an investigation which

[1] See Accounting Review, December, 1928, pp. 345–363; March, 1929, pp. 23–32; June, 1931, pp. 113–117; June, 1934, pp. 171–175; March, 1935, pp. 13–16.

[2] "The Evolution of Elementary Cost Accounting Theories and Techniques," a doctoral thesis recently accepted by the University of Texas in partial fulfillment of the requirements for the Doctor of Philosophy degree. It was not found practical, however, to incorporate any large part of the results of the investigation in the thesis; and, since quite a number of the persons to whom questionnaires were sent expressed an interest in the results, the present article was prepared.

may throw some light on the subject, especially as to what various individuals feel should be the contents of the course.

A questionnaire containing 19 questions was prepared and mailed to 424 cost teachers in all sections of the United States.[3] Some 247 replies were received, which represents a 58.3% return—much larger than usual for a mailed questionnaire, and probably both an adequate and representative sample. Some difficulty was experienced in deciding how to word the questions on course content, since strictly general questions would have been impossible to tabulate satisfactorily. It was finally decided to translate the problem of course content into the relative space which *should be* devoted to the topics in the textbook used in the cost course. Since most cost instructors tend to teach what is in the text (especially in the elementary course) questions could be worded in a fairly definite fashion through the adoption of the textbook space approach. The problem resolved itself, therefore, into: What should be the contents of the elementary cost text?

I

Two questions of an introductory nature were asked. The first was:

In what type of community is your university or college located? The answers to this question can be tabulated as follows:

Type of Community	*Number of Answers*	*Percentages*
Industrial	124	50
Agricultural	84	34
Distributing	39	16
Total	247	100

[3] The writer wishes to take this opportunity to express his appreciation for the coöperation and suggestions received from the persons who filled out and returned the rather lengthy questionnaires. Obviously, without their help, the present investigation would have been impossible. Incidentally, the 424 instructors represent the 325 different institutions which offer at least one organized course in cost accounting in the United States.

The purpose of this question was to see if there were a predominant demand for the cost course in industrial localities. As would be expected there was a large percentage (slightly more than 50%) of the cost courses being offered in industrial communities, but the agricultural and distributing centers also had fairly high figures. Obviously, the mere location of the institution is not altogether the controlling factor; the place to which the students return is probably more important. Another question was asked, therefore, to settle more conclusively the latter point.

The second introductory question was:

How much time does your institution devote to cost accounting?

		Number	*Percentages*
One Semester	119		
One Quarter	22	141	59
Two Semesters	72		
Two Quarters	11	83	34
Three Semesters		7	3
Three Quarters		5	2
Four Semesters		3	1
Five Semesters		2	1
		241	100
No Answers		6	
Total		247	

The addition of the one-semester group to the one-quarter group, and the two-semester courses with the two-quarter courses, is of doubtful validity; it is made above merely for the purpose of emphasizing the two totals. As is well known, the amount of class room time and preparatory time also varies considerably between institutions offering cost accounting. In fact, some instructors cover almost as much in one semester (because of more class time available) as others cover in two. In spite of this element of non-comparability, however, the above table indicates that over one-half of the instructors

questioned taught in institutions which offered only what might be called an "elementary course in cost accounting." This is indeed a large percentage, and it may be higher than is generally believed.

II

The second part of the questionnaire dealt with the contents and the basic approach of a complete cost accounting course given in one semester or quarter, not to be followed by any additional formal work in the subject. Thirteen questions were included in this part. The principal point of view was to try to determine what should be the contents of the strictly elementary cost course, where the student did not have an opportunity to continue his work at the same institution even if he cared to do so. The questions and results were:

Question 1. In your opinion should the contents of the one-term cost accounting course be affected by the type of community (industrial, distributing, agricultural) to which your students return?

	Number	*Percentages*
No Effect	171	70
Very Definite Effect	73	30
	244	100
No Answers	3	
Total	247	

The instructors questioned were predominantly of the opinion, therefore, that the contents of the first course should be governed by factors other than the type of locality to which the students return after leaving the institution. This matter is obviously associated with the basic purpose of the cost course and is treated in more detail in a later question.

Question 2. How much attention should be devoted to standard costs in a one-term course?

	Number	*Percentages*
Omitted Entirely	23	9
Mentioned Only Briefly	73	30
The Accounting Techniques Illustrated in:		
One Chapter	74	30
Two Chapters	72	30
Three Chapters	2	1
	244	100
No Answers	3	
Total	244	

In recent years, the preceding question has become of increasing importance, and while a fairly large percentage of the instructors indicated that the subject might either be omitted or mentioned only briefly a greater percentage think the subject of enough significance to have one or more chapters of the one-term course text devoted to the topic.

Question 3. How should budgets and budgetary control be treated?

	Number	*Percentages*
As a Part of the Uses of Cost Accounting in Management	95	40
In a Separate Chapter	86	36
As a Part of Burden or Overhead Control	56	24
	237	100
No Answers	10	
Total	247	

This question was primarily one of the teaching approach, rather than content. The results are interesting, therefore, only in so far as they indicate the personal opinions of the 237 instructors who answered this question.

Question 4. In your opinion, is a practice set necessary in a one-term cost course?

The word "necessary" may have had some bearing on the opinions of the 69 teachers who answered "No" to the question as to the practice sets. For example, if the word "desirable" had been substituted,

	Number		Percentages
No	69		29
Yes. If So, Should It Be Concerned With:			
A Hypothetical Firm Using Job Costs	85	35%	
A Hypothetical Firm Using Process Costs	5	2	
A Hypothetical Firm Using Job Costs at First and Later on Process Costs	81	33	
A Hypothetical Firm Using Process Costs At First and Later on Job Costs	2	1	71
	242		100
No Answers	5		
Total	247		

a larger number might have answered "Yes." The interesting feature of the answers is the large number who felt it necessary that the set be concerned with both Job Costs and Process Costs; and the still larger number (71%) who considered some sort of a practice set absolutely necessary.

Question 5. What should be the media through which the basic (beginning) approach to the one-term course is made?

	Number	Percentages
Job Costs	183	77
Process Costs	54	22
Both Job Costs and Process Costs	2	1
	239	100
No Answers	8	
Total	247	

The traditional introduction to cost accounting is upheld in the answers to the preceding question. In fact, there was more agreement on this point than on any of the other "content" or "approach" questions. No questions were asked as to why the instructors preferred their particular choice; the answers to a "reason for preference" question would have been interesting even though very general.

Question 6. To what extent should flow charts and diagrams be used in a cost accounting course?

	Number	Percentages
In Large Number	53	22
In Moderate Number	139	57
Sparingly or Limited	52	21
	244	100
No Answers	3	
Total	247	

The subject of the proper use of flow charts and diagrams in the cost course is one of perpetual debate. The answers to the preceding question show that cost teachers think them desirable by a majority opinion, but a sizable percentage (21%) believe that their use can be overemphasized.

Question 7. How much attention should be devoted to by-products and joint products costing in a one-term course?

	Number	Percentages
Omitted Entirely	18	7
Treated Briefly (two or three pages)	104	43
Given a Separate Chapter	122	50
	244	100
No Answers	3	
Total	247	

Not many years ago, the subject of by-products and joint products costing was considered a rather advanced topic, not to be touched upon in a one-term course. Evidently the opinion has shifted, since exactly one-half of the persons who answered the question thought the problems worthy of a separate chapter, even in the one-term course. No indication of the length of such a chapter or the thoroughness of its presentation can be gained from the results of the questionnaire, but the subject has be-

come of definite importance in the minds of cost instructors.

Question 8. How much attention should be devoted to distribution and commercial costing in a one-term course?

	Number	*Per-centages*
Omitted Entirely	35	15
Treated Briefly (two or three pages)	93	39
Given a Separate Chapter	112	42
	240	100
No Answers	7	
Total	247	

This topic has become increasingly important in the past ten years, and a fairly large percentage of the instructors feel that it merits at least a separate chapter in the one-term cost text. Another large percentage, however, think that the elementary cost student should be given only a bare introduction to the subject in two or three pages.

Question 9. To what extent should wage plans or systems be treated in a one-term course?

	Number	*Per-centages*
Treated Briefly (two or three pages)	66	27
Consolidated with the Accounting for Labor	142	58
In Detail in a Separate Chapter	36	15
	244	100
No Answers	3	
Total	247	

Several of the older texts presented wage plans as an independent phase of cost accounting, with very little effort being made to relate the plans to the techniques of cost accounting. It appears from the answers to this question, however, that a large majority of cost instructors consider wage systems important only insofar as they influence the accounting for labor.

Question 10. How much attention should be devoted to the matter of installing cost systems in the one-term course?

	Number	*Per-centages*
Omitted Entirely	105	43
Treated Briefly (two or three pages)	88	36
Given a Separate Chapter	51	21
	244	100
No Answers	3	
Total	247	

Most of the instructors evidently feel that the matter of installing cost systems should not be dealt with extensively in the one-term course. It may be that they consider the matter important but that other topics are relatively more significant. In addition, some institutions deal with cost installations in the accounting systems course.

Question 11. How much attention should be devoted to trade association cost activities and uniform costing in the one-term course?

	Number	*Per-centages*
Omitted Entirely	74	30
Treated Briefly as a Part of the Uses of Cost in Management	154	63
Given a Separate Chapter	17	7
	245	100
No Answers	2	
Total	247	

Question 12. What should be the course prerequisites for the first course in cost?

	Number	*Per-centages*
Elementary (Basic) Accounting Course Only	161	65
Elementary Accounting Plus Course in Management	63	26
Elementary Accounting Plus one Semester of Intermediate Accounting	16	6
Elementary Accounting Plus a a Course in Budgets	7	3
Total	247	100

This question was asked in an attempt to determine if any uniformity of opinion existed among cost instructors with regard to requisite preliminary preparation of students. All agreed that the basic elementary course in general accounting was necessary, and quite a number feel that additional background is desirable (especially a general course in management). The question was worded in terms of "what *should be* the course prerequisite?"; a study of actual required prerequisites made might disclose differences due to curricula difficulties, type of institution, and other courses offered. It would be interesting to know if the trend were toward more prerequisites, or less; the present investigation gives no clue.

Question 13. Considering the needs of a *majority* of your cost students, what should be the *basic purpose* of the one-term course in cost?

	Number	*Percentages*
(a). Part of Their Preparation for Public Accounting Work	27	11
(b). Part of their Training for More Effective Business Management	107	44
(c). To Increase their Understanding of, and to Make more Usable Their Knowledge of, Elementary Accounting	66	27
(d). Basic Training for Industrial Cost Department Positions, i.e., Technical Positions	42	18
	242	100
No Answers	5	
Total	247	

The purposes listed are not mutually exclusive; as a few correspondents pointed out, there could be more than one basic purpose which could be satisfied at the same time. In order to get some definiteness in the replies, however, the question was worded as above, and at least one interesting fact was brought out: a large percentage of cost instructors do not feel that their one-term cost students are taking the course for technical or public accounting purposes. Parts (b) and (c) of the question are closely related from the standpoint of the objective of the one-term cost course, and they received 71% of the total. Stated differently, 71% of the cost teachers make "increasing the accounting and general business management knowledge of their students" the basic purpose of their course. The first course in cost accounting, is no longer looked upon as a highly specialized technical study, but as an additional phase of accounting suitable for all students who desire a more rounded background in general business training. From this viewpoint it would appear that the contents of the one-term course should be primarily adapted to the needs of the latter class of students, rather than technically minded ones. The technical student would probably suffer no handicap if the contents were general in nature; he would need all the information he could obtain anyway.

III

The third part of the questionnaire contained four questions dealing with the course content if more than one course in cost accounting were offered in the institution. Since the questions were concerned with what should be the course contents, the cost instructors were requested to answer the questions even though their particular institution gave only one-term courses. It will be remembered from the table on page 344 that 141 instructors were offering only one-term courses, out of a total of 241. Many of the one-term instructors availed themselves of the opportunity of expressing their opinions, and practically all of the more than one-term teachers answered the four questions in this part of the questionnaire.

Question 1. In your opinion, should the contents or subject matter of the first

course in cost accounting be influenced or affected by the fact that advanced cost work is available for your students?

	Number	Percentages
Yes	127	65
No	69	35
	196	100
No Answers	51	
Total	247	

This is a question which has been of interest not only to cost instructors, but to other teachers as well. Should the first course in a subject such as cost accounting, business statistics, banking, investments, corporation finance, etc., be taught as though the student will not take more formal academic work in that particular subject; or, should the assumption be made that the large majority of the students will take additional work? The course contents should not be exactly the same in each instance. Even in those institutions that offer more than one cost course, a large majority of the students take only the first course. It should seem, therefore, that the course contents should be governed entirely by the needs of those who will not continue; the advanced student will have ample opportunity to acquire the finishing touches. While this particular question was worded in a rather general manner, and did not ask how much influence there should be on the content of the first course the majority of the instructors agreed that there should be an allowance made for the fact that advanced work was available, even though many students never took advantage of it.

Question 2. Should the first semester or quarter course deal exclusively with what may be called "actual costing," leaving estimated and standard costing for the advanced course or courses?

This, again, is a question concerned with content of the first course if second or third

	Number	Percentages
Yes	132	69
No	58	31
	190	100
No Answers	57	
Total	247	

courses are available. In the table on p. 345, accompanying Part II, 61% of the instructors considered that standard costs should be elaborated upon, even if only a one-term cost course were offered. Yet 69% of the teachers feel that if more than one cost course is available for their students, the standard cost discussion should be carried over to the advanced course or courses. This is not entirely consistent if the supposition be true that a large majority of students take only the first course, even though more than one course is included in the curriculum. No question was asked, however, as to the approximate percentage of students who take the advanced work, as contrasted with those who stop at the end of the first course.

Question 3. Considering the needs and interests of a majority of your cost students, what should be the basic purpose of the first course in cost accounting if a second or advanced course is available for your students?

	Number	Percentages
(a). Part of Their Preparation for Public Accounting Work	20	11
(b). Preliminary Basic Training for Industrial Cost Department Positions	32	18
(c). Part of Their Training for More Effective Business Management	80	44
(d). Background or Preparatory Work for the Advanced Cost Course	49	27
	181	100
No Answers	66	
Total	247	

As in Question 13, Part II, these objectives are not mutually exclusive; many instructors feel that more than one of the purposes may be adequately satisfied at the same time. The answers are revealing only in so far as they indicate the viewpoint of those teachers who have an opinion as to a single basic purpose.

Question 4. Considering the needs and interests of a majority of your students, what should be the basic purpose of the second or advanced course in cost accounting?

	Number	*Percentage*
(a). Part of Their Preparation for Public Accounting Work	52	29
(b). Further Training for Industrial Cost Department Positions, i.e., Technical Positions	80	44
(c). Part of Training for More Effective Business Management	50	27
	182	100
No Answers	65	
Total	247	

Parts (a) and (b) of this question are obviously somewhat related in that both consider the second course as being needed for specialized purposes. A majority of instructors looked upon their advanced cost course or courses as fulfilling the need for specialized training. It is surprising however, that 27% of the 182 teachers feel that the basic purpose of the second course should be preparation for more effective business management. Evidently, even the more advanced phases of cost accounting are becoming more important for business executive purposes.

SUMMARY

The study of cost accounting has come to occupy a significant place in schools or departments of commerce. Many instructors feel that it should be part of the preparation of students who have no particular fields of business specialization. No longer is it looked upon as a subject for accounting majors only; the contents of the course should, therefore, be adapted to the needs of both the accounting major and the general business student.

It would be interesting to know if graduates, who had studied cost accounting, and later became associated with various fields of business, would agree with the opinions of cost instructors on course content. It is possible that their views might differ, at least in some instances, from those of their teachers.

SOME UNSETTLED PROBLEMS OF INCOME

RUSSELL BOWERS

MUCH HAS BEEN written about income for tax purposes. Some writers have been concerned with concepts and definitions; some have been devoted to the more detailed problems of measurement. A study of the concepts and definitions shows a great variety of opinions among writers from such important countries as the United States, England, France, Germany, and Italy.[1] The concepts of taxable income which have been

[1] See for instance a series of articles by Professor Paul H. Mueller, *Political Science Quarterly*, Vols. 53 and 54, March, 1938, December, 1938, and December, 1939. The work of Professor Henry C. Simons, *Personal Income Taxation* (University of Chicago Press: 1938) also will illustrate.

presented often come writers in political economy who have in view some special social or national fiscal policy. The concept sometimes has an ethical flavor other than the capacity of the individual to pay. The types of definition vary greatly in fundamental content. At one extreme is the idea that income is determined by the disposition made of the form in which it is embodied while at the other extreme is the idea that there is income only after there has been ample deduction for both consumption and capital maintenance. There are innumerable combinations of the two criteria of consumption and accumulation.

Sometimes there is failure on the part of the writer to consider the purpose for which the definition is to be used. Frequently there is little consideration of the relative rights of individuals. Many of the concepts advocated have not received recognition from legislatures or other governing authority. The attempt to find an appropriate definition in legal sources will yield little success. Here the concepts applied vary with expediency, social and political ends, or other consideration not based on individual capacity.

It has been the practice in this country to tax certain gains realized in the legal sense, but often a naive concept of realization is applied. In general realized gains may be either consumed or saved. There has been great emphasis upon the sources from which gain is derived and this has gone hand in hand with failure to stress the composite income status of the individual. Such a situation tends to defeat the effectiveness of graduated rates. There is often unfair discrimination as between individuals whose composite respective income situations might in fact be similar. Despite all the attention the subject of income has received the courts, legislative and administrative bodies do not have at their disposal any well-defined, equitable, and at the same time administratively feasible concept of taxable income. In fact there seems to have been an abandonment of any well-defined concept.

Does the ability-to-pay theory apply to individuals or does it apply to all persons—natural and artificial? It is probable that advocates of the capacity principle have had in mind only natural persons. Failure to take this assumption into consideration together with a tremendous extension of the use of the corporate form of business enterprise has resulted in considerable injustice. A tax at graduated rates on corporate income is in general a penalty on mere size of organization and concentration of investment and control.

When an analogy between the corporation and the natural person is followed there results a measure of unjustifiable discrimination as to type of financial structure. There is a great deal of discrimination against a financial structure consisting of stock. The assumption that a corporation with a financial structure of stocks and bonds is analogous to the individual who borrows and has net worth merits further study.

At the present time the government is forced to search for more tax-gathering possibilities. It is proper that we should again examine the concept of taxable income with the end in view of raising maximum revenue with a minimum of unfairness to individual taxpayers. It is to be hoped that the boundaries of an appropriate concept can be more sharply drawn and that some contribution can be made to a final settlement of the income-tax base. It is realized that the taxpayer is greatly over burdened by a complex tax structure, but it is also believed that it is possible to discover a sufficiently equitable income base that frequent changes will become unnecessary. Much of the apparent complexity is the result of too frequent changes.

It is often ponited out that income periodically determined for a going concern is

at best an estimate. Many assigned costs are more or less of an arbitrary nature. The income side of the account has perhaps drawn less attention than the cost side, but many arbitrary decisions are made concerning the income side. In accepting sale as the ultimate in income realization perhaps too great emphasis is placed upon only one event in a chain of events all of which contribute to income. Realization criteria have long offered baffling legal and business problems.

No legal conception of income can be an equitable tax base for individuals if it ignores economic and business realities. The realization question is scarcely settled in law and it is little less problematical in business. What are the circumstances accompanying legal sale which make this event a peculiarly appropriate occasion for recognizing income or loss? Examination might reveal that the essential characteristics of realization are not always accompanied by legal sale.[2]

For tax purposes it is essential that some kind of accounting definition of income be applied. Associated with accounting definitions are usually two sets of parallel but opposing data which must be matched one against the other in order that a balance may be emphasized. This is necessary because income is not often found first as net. The importance of the proper matching of these sets of positive and negative data makes the time of setting up the account a crucial matter. The opportuneness of setting up one side usually determines the opportuneness of setting up the other. Ordinarily, though not always, the appropriate occasion for matching positive and negative income data is controlled by the income side of the account. Thus in some respects "gross income" is more important than deductions. During times of steeply graduated annual income tax rates it is as important to know when income should be reported as it is to know how much income should be computed. Generally speaking accounting literature has neglected the subject of gross income. Many writers have taken a knowledge of gross income for granted.

Income is frequently described as a flow after the analogy of a stream of water. In accounting the suggestion is unfortunate. There are few actual similarities. Gross income must usually be considered as a function of discrete events rather than a continuous flow. Business income can be shown to be a continuous flow only in a few cases such as the earning of interest under contract. This source which is often used to illustrate the character of income is hardly typical. More important cases are those which involve production when it does not proceed under a contract underwritten by another party. The flow theory has the additional limitation of emphasizing recurrence or regularity. This involves giving weight to the intention of the recipient and income based on intention is scarcely the same as income based on fact.

Accounting has tended to take a business-entity point of view with respect to income determination. This has the merit of placing emphasis upon the results of management and of measuring the economic success of a particular venture which lends itself to treatment as a distinct producing unit; but this has shifted the emphasis away from the individual who might be the most appropriate taxpaying entity. The composite income status of the individual is thus made more obscure than might otherwise be the case. The extension of use of the corporate form has contributed toward this result. Emphasis on the business entity and management rather than on the individual who has an equitable interest in the enterprise is consistent with emphasis on source

[2] A recent study by Franklin H. Cook considers the legal rather than the economic side of the problem. See ACCOUNTING REVIEW, March, 1940, pp. 355–367.

rather than ownership. If ownership is considered it is the ownership of the enterprise rather than of the individuals who own the enterprise. It might be more appropriate from the tax angle to place less attention upon sources and more upon the fact of existence of income and its ownership allocation.

It is an accepted canon of good accounting that before income can be recognized there must be proper provision for the preservation of any capital sources. It is further important that the provision for capital maintenance be made in terms of the same accounting period and the same accounting entity which pertains to any possible increment of income. These rather obvious requirements are not always followed when dealing with the relationship between stockholder and corporation. In the case of corporate distributions the generally accepted standards are ignored. The effective receipt of a dividend by a stockholder is the decisive factor in the measurement of a stockholder's income. From the stockholder's point of view there is no attempt to provide the appropriate maintenance of capital. At the present time corporate distributions are characterized by considerable irregularity both with respect to amount and time of receipt. This condition magnifies the problem. An extraordinary dividend might easily be the return of capital if the stock is of recent purchase. Again it might be the mere transfer of measured, available earnings properly accrued to the corporation in a previous fiscal period. It is thus a capital conversion rather than income for the period of receipt. Conversely the accumulation of riches in the name of a corporation might be an effective means of acquiring a fortune while avoiding the appropriate individual surtax brackets.

The possibility of recognizing income as measured, available increment not necessarily based upon cash receipt has not been fully considered. The subject of losses in this connection might also receive more careful consideration. The fact that corporate income might be assigned to stockholders upon effective realization by the corporation has been suggested by a few writers and the idea is not entirely without support in law, but there has not been a general awakening to the possibilities of this means of solving the corporate dividend problem. If this procedure is feasible from an administrative standpoint some problems which suggest an undistributed profits tax can be equitably settled. There can be greater equity in the taxation of individuals at graduated rates. The same theory of capital maintenance as is advocated in other income situations can also be applied here. Finally the unjustifiable discrimination between different types of corporate financial structure can be avoided.

THE DEFINITION AND MEASUREMENT OF INCOME

ROBERT B. BANGS

THERE HAS long been need for a greater degree of agreement among economists, accountants, and statisticians regarding the problems of defining and measuring income. Although some differences are probably inevitable, because of various problems in the three fields, the amount of overlapping of subject matter is large, and a common approach would add clarity to each discipline

as well as strengthening the interrelationships between them.

The accountant is interested primarily in the business unit, and his chief function may be held to be the accurate measurement of periodic income as it accrues to the firm. In this task he is aided by a body of accounting conventions and "principles," some of which are grounded in law[1] or in economic analysis, while others are merely "rules of thumb" which have been tried and found convenient. There is an increasing amount of theoretical analysis behind the practical work of a modern accountant, but this theory is as yet incomplete and subject to many unsettled controversies, several of which involve fundamental differences of opinion regarding income measurement.

As is well known, complete accuracy in the measurement of business income may be realized only upon the expiration of the firm's life, at which time the entire income, for the whole life of the enterprise, may be determined without error, assuming complete and accurate accounting records. But the practical problem is that of measuring the income of a going concern for short periods (years or months) with speed, precision, and minimum expense. Problems of valuation, questions of depreciation or appreciation, and techniques of allocation for revenue and expense are basic to the measurement of income. While the practical nature of accounting work has, in the past, often developed methods lacking precise theoretical groundwork (e.g., the lower-of-cost-or-market rule as applied to inventories), the increasing complexity of business enterprise and the use of more analytical methods by management have continually demanded more accurate accounting, and forced into the discard makeshift conventions in favor of more scientific procedure. But since the accountant is primarily the servant of management, he is less concerned with logical and philosophical questions than the economist or (perhaps) the statistician, whose problems are less specific, and whose horizons are (sometimes) broader.

THE INCOME CONCEPT IN ECONOMIC ANALYSIS

The economist may be led to the problem of defining income by many paths. As a student of production and exchange he follows a theory of value which, in its modern form, is essentially a refined and generalized calculus of choice.[2] Individuals are presumed to behave in such a manner as to maximize satisfaction within limits set by their preferences and the weights given to these preferences by their incomes. Firms are engaged in an effort to maximize the strength of their economic positions, or that of their control groups, usually, the economist assumes, through striving to maximize income in some sense. As a student of human welfare, regardless of whether or not this is within the purely scientific part of economics, the economist frequently uses some concept of income as an index of well-being, either in the case of persons or groups. For example, the national income or dividend is a basic concept in comparative welfare economics.

While economists may, and often have, employed definitions of income which are convenient for their particular purposes, without regard to the lack of correspondence between their usage of the term and that found in other fields, there is a certain awkwardness in such procedure. Economics purports to explain, at least in a

[1] It is especially important in accounting theory to isolate the effect of legal precedent, which, according to one writer, is "not only arbitrary and coercive but often capricious." Cf. S. Gilman, *Accounting Concepts of Profit*, New York, Ronald Press, p. 9.

[2] Cf. J. R. Hicks and R. G. D. Allen, "A Reconsideration of the Theory of Value," *Economica*, February, 1934, pp. 52–76.

general way, the behavior of businessmen, since it constructs theories which make assumptions regarding entrepreneurial behavior. When the economist alleges that the businessman's aim is to maximize income, he does well to remember that the results of this endeavor, on which the businessman judges the results of past performance and to some extent moulds future policy, are reported to management as a product of accounting. Thus it is really the accountant's definition of income which is controlling in a large area of business practice.

THE PROBLEM OF RECONCILING DEFINITIONS

Statisticians frequently have occasion to gather, use, and interpret data dealing with income. In measuring national income, for example, many problems of aggregating, double counting, and estimating are involved. The basic data, however, are drawn largely from accounting records such as tax returns, and income statements. Clearly statisticians are obliged to define income in such a way as to facilitate reconciliation with the conception used in the primary collection of raw data, i.e., by accountants. Economists, when using business income figures, either to test theories, or to observe associations which suggest new hypotheses, are also constrained to recognize that it is the accounting conception of income which they are using in work of this sort, and that their own points may be logically drawn only if their conception of income is plainly reconcilable with that on which the figures are based.

The fact that accounting provides some of the raw data with which both the economist and the statistician work might suggest that definitions in these fields should be adapted to closer conformity with accounting practice. In the case of some definitions, Fisher's concept, for instance, which regards income as a flow of services accruing to consumers, and which excludes saving from income,[3] this adaption is undoubtedly desirable.[4] But the definition of income in accounting is not without its controversies also, and in many cases it is possible to throw light on these dark places by referring to economic analysis or statistical practice.

In dealing with questions of definition it is desirable to follow the dictum of logic that "definition is the analysis of the connotation of a term,"[5] where we understand that the connotation of the term refers to those attributes which enable us to apply the term to a given object or class of objects, and lacking which we could not correctly apply the term to the object or idea we have in mind. The definition of a term should be extensive enough to embrace all types or manifestations of the idea defined, and restrictive enough to exclude all ideas not properly belonging to the class defined. In addition, we may accept Fisher's rough specifications for a good definition, namely, that it should be useful for scientific analysis, and in conformity with popular usage.[6] Although it may be impossible to fulfill all these logical and practical requirements, they represent the objectives of a workable definition of income.

CLASSIFICATION OF INCOME CONCEPTS

The simplest conception of income is that of a flow of services or benefits through time. This broad idea may be broken down into three distinct concepts:

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[3] Irving Fisher, *The Nature of Capital and Income*, New York, Macmillan, 1906, pp. 51–52; 134–135; 246–255.

[4] At present there seems to be general agreement among students of income that Fisher's concept is unsatisfactory. Cf. W. W. Hewett, *The Definition of Income and Its Application in Federal Taxation*, Philadelphia, Westbrook Publishing Co., 1925.

[5] S. H. Mellone, *Elements of Modern Logic*, London, University Tutorial Press, 1934, p. 51.

[6] I. Fisher, *The Income Concept in the Light of Experience*, New Haven, 1927, p. 2.

psychic income, money income, and real income. Psychic income refers to the satisfactions realized by individuals through the employment of wealth. It is generally taken to exclude saving, since the satisfactions resulting from consumption and those associated with saving are hardly comparable. Although the idea of psychic income was common in older forms of economic theory, it has but a restricted usefulness due to the fact that, as a magnitude for groups of individuals, it is meaningless, since subjective satisfactions realized by different persons are not additive.[7] For present purposes, therefore, the concept of psychic income is avoided. This paper is concerned only with money income—income measured in terms of money though not necessarily received in the form of money, and with real income as a derivative concept.

Money income, the value of services or benefits, measured in terms of a common unit of account, accruing during a period, is the central concept for accounting, economics, and statistics, and the area in which the best reconciliation of different concepts may be expected to be attained.

The term "real income" refers to money income expressed presumably in some unchanging monetary unit, i.e., corrected in some fashion for price changes. This notion, besides being important for welfare economics, likewise provides the rationale for methods of statistical "deflation" and lies at the root of schemes for stabilized accounting.

In modern economic analysis, which is concerned frequently with expectations and their effects as motivating forces in economic processes, it is usual to distinguish *ex-ante* and *ex-post* meanings for many fundamental terms. The terms "expected income" to indicate a given constellation of anticipations, and "obtained income" to describe an amount reckoned at the termination of a period may be used to separate these two ideas.[8] "Obtained income" and "realized income" are not always synonymous in that the former assumes an accrual basis of accounting throughout, whereas the latter is sometimes used by accountants in senses which specify a receipts test for certain items, failing which test income is not recognized.[9]

CAPITAL

"Expected income" may be taken in economics as referring to the continuous prospective appreciation of capital values in association with time. Introduction of the term "capital" at this point calls to mind what has long been recognized as a vital problem in both economics and accounting, namely, that "the conceptions of capital and income are so interwoven that the determination of one is impossible without that of the other."[10] Escape from this dilemma is virtually impossible but coördination of the concepts of capital and income involves acceptance of a valuation definition of capital. This view, deriving from such writers as J. B. Clark[11] and Cannan, holds that capital is in essence a stock of value deriving from rights for the acquisition of future services. Such a definition, which makes capital analogous, but

[7] L. Robbins, "Interpersonal Comparisons of Utility," *Economic Journal*, December, 1938, pp. 635–641.

[8] The terms are used by E. Lindahl, "The Concept of Income," *Economic Essays in Honor of Gustav Cassel*, London, Allen and Unwin, 1933, p. 400.

[9] Most accountants now favor recognizing "realized income" upon the exchange of property or services for legal claims, presumably realizable, to cash. If used in this sense "obtained income" and "realized income" may be interchangeable. This need not be the case, however, if the same deductions are not made in calculating net from gross income. For this reason the two terms are required. Cf. S. Gilman, *Accounting Concepts of Profit*, p. 98.

[10] F. A. Fetter, "Reformulation of the Concepts of Capital and Income in Economics and Accounting," Accounting Review, March, 1937, p. 4.

[11] Cf. F. A. Fetter, "Clark's Reformulation of the Capital Concept," *Economic Essays in Honor of J. B. Clark*, New York, Macmillan, 1927.

not synonymous with "assets," must be separated from the Ricardian-Bohm-Bawerkian definition of capital as "produced means of production." This latter definition identifies capital primarily with physical equipment rather than valuations, and stresses the technological aspect of production rather than the valuation process and the distribution of income.[12] "Capital" in the Ricardian sense must be denoted in the present classification either by the generic term "wealth," or it must betreated as a loose group of "agents of production" if confusion is to be avoided.

WEALTH, CAPITAL, AND ASSETS

Following Fetter, it is advisable to distinguish carefully between "wealth," "capital," and "assets." In his words, "capital is essentially a financial concept relating to business investment, and including the present market valuation of all legal rights to income possessed by natural persons."[13] The term "assets" will be used to refer to the values of claims to service possessed by artificial persons (corporations) or by natural persons in their capacity as business firms. This definition of assets as the properties of business firms is best interpreted in light of the "entity convention" of accounting, the convention that the business enterprise, whether incorporated or not, has a distinct existence separate from that of its owners, and that the firm "constitutes a real institution, through which flows a stream of values."[14] The term "wealth," although it assumes measurement in money terms, will be used chiefly to focus attention on the physical resources which underlie capital valuations.[15]

The definition of capital as the valuation of all rights to income possessed by natural persons is in accord with that section of accounting terminology which views capital as one of the equities in, rather than the properties of a corporation. Strictly speaking a business firm has only assets and equities and no "capital" as I have defined the terms. Insofar as the term capital is applied to a business entity, then it must refer to the capital of proprietors in the entity, i.e., the proprietorship equity in the business. Popular usage, which sometimes identifies the "capital" of a firm with the total of its assets, is not in conformity with the requirements of this particular classification of terms.

Although "expected income" is considered to be measured in part by the yield on capital, in the broad sense, through time, it must be regarded as originating in, and flowing from, the combination of wealth, as defined above, and human resources. Although human resources (labor and technique) are clearly within the range of agents or factors from the standpoint of the theory of production, they are customarily counted as wealth or capital because of their intangible nature.[16]

INCOME AND INTEREST

In classical economics it was customary to identify "capital," in the physical sense, with a particular type of income flow,

[12] However, the physical aspect of capital may be made to serve as the basis for a theory of distribution, as it did with Ricardo.

[13] F. A. Fetter, ACCOUNTING REVIEW, March, 1937, p. 9.

[14] W. A. Paton, *Accounting Theory*, New York, Ronald Press, 1922, p. 473.

[15] This is similar to the definition used by Kuznets and the National Bureau of Economic Research. National wealth is estimated by summing individual capitals and eliminating the double counting. Cf. "On the Measurement of National Wealth," *Studies in Income and Wealth*, Vol. 2, 1938, pp. 3–82.

[16] Some economists have suggested that technical knowledge should be counted as a part of capital equipment. Perhaps the chief reason for excluding knowledge from the category of capital is that it is so definitely a personal property, having no existence apart from that of some natural person. Cf. L. M. Fraser, *Economic Thought and Language*, London, A. and C. Black, 1937, p. 244n.

namely interest. Under the present definitions all non-wage income must be regarded as, in a sense, representing "interest" on capital, as defined in the valuation sense.[17] Thus it is convenient to break with the idea that interest is the reward of any specific class of factor of production, and to accept the notion that interest, as an income stream, is associated only with investment in a particular sub-group of assets—those assets satisfying certain liquidity requirements, or possessing other specific attributes. The question of what precise group of assets may be said to yield interest rather than rent goes deep into the field of interest theory, at present an extremely controversial segment of economic analysis.

EXPECTED INCOME

The concept "expected income" plays a very important role in that part of theoretical economics which is concerned with developing explanations of cumulative fluctuations in employment and prices. Analysis of this type, associated with the names of J. M. Keynes and the Swedish followers of Wicksell (Myrdahl, Lindahl, and Ohlin), is worked out largely in terms of saving-investment sequences, and the effects of these sequences on price levels and the volume of economic activity. A few years ago it was common to associate some form of cumulative price and output movements with savings-investment disequilibrium or inequality.[18] Most of those economists who have followed the savings-investment discussion carefully are agreed[19] that *ex-post* saving, i.e., the unconsumed margin of "obtained income," and *ex-post* investment, or that part of "obtained income" devoted to the purchase of assets, are equal *ex-definitione*.

The saving-investment nexus still retains importance, however, since planned saving (the portion of expected income which individuals do not intend to devote to consumption), may differ from prospective investment (the portion of expected income which is earmarked for addition to capital). Cases such as this, where expectations are inconsistent, tend to cause "obtained income" to exceed or fall short of "expected income," depending on whether prospective investment exceeds or falls short of planned saving. In this fashion saving and investment become the twin determinants of changes in price levels and output.

Although the idea of "expected income" plays no important part in accounting when the latter is viewed as a historical record exclusively, the concept is central in several branches of modern industrial accounting work. Budgeting may be regarded as aimed at the predetermination of income, and the budget itself as a systematic, formal process of income estimation. Likewise, in those firms using "standard costs," where these predetermined figures are so drawn as to reflect actually expected and not ideal levels of attainment, expected income may be defined as the difference between budgeted revenue and the "standard cost" of prospective output. Needless to say, not all standard cost systems are of this type.[20]

In statistical work "expected income" is not a concept of great moment except in-

[17] Cf. E. Lindahl, "The Concept of Income," Essays in Honor of Cassel, p. 400 ff.

[18] This is the original method of Wicksell, and that of Keynes in 1930. Cf. *A Treatise on Money*, New York, Harcourt Brace.

[19] An exception should be made in the case of those who follow Robertson's terminology, and define current saving as the unconsumed portion of the previous period's income, while investment means that part of the current period's income not destined for consumption expenditure. Cf. D. H. Robertson, *Banking Policy and the Price Level*, London, P. S. King, 1926; Saving and Hoarding, *Economic Journal*, September, 1933; also *Essays in Monetary Theory*, London, P. S. King, 1940.

[20] The distinction between budgeted costs and other forms of standard costs has been well analyzed by E. A. Camman, *Basic Standard Costs*, New York, American Institute Publishing Co., 1932.

sofar as the budgeting and standard-setting tasks of business management may be regarded as statistical, rather than accounting functions. Other applications may be found in such problems as that of estimating the prospective yield of income taxes, or that of forecasting investment activity.

II

When the unmodified term "income" is encountered, either in economics or accounting, it is generally "obtained net income" which is implied. Since the measurement of obtained net income is the basic problem of financial accounting, and since this problem turns largely on the twin points of separating capital from income, and specifying precisely what is meant by the notion of "maintaining capital intact," any discussion of income measurement is is bound to center around these points. But first a glance at the economic interpretation of the concept "obtained income" is desirable.

Income may be regarded either as the value of new wealth currently produced less, of course, wealth consumed in the process, or as rights to wealth currently distributed to persons and business firms. The former idea identifies "obtained income" with the physical goods and intangible services which are the outcome of current production processes, while the latter refers to the rewards received by owners of agents of production in return for their efforts. In total, obviously, both senses agree, since rights of acquisition arise simultaneously with all current production. Modifications of these two notions may be found in the statistical problem of measuring national income, where the usual American practice is to distinguish "income produced" and income paid out." "Income paid out" and "obtained income" (distributed)) are not identical, since the former excludes while the latter may be said to include earnings retained by business enterprises. The difference between income produced and income paid out thus given a rough estimate of the volume of *ex-post* saving performed by business firms.

ACCOUNTING FOR INCOME

Traditional accounting practice regards obtained income as the difference between gross revenue and the historical cost of obtaining that revenue. Since an accrual basis of calculation is usually applied to revenue, this concept is identified usually with net sales and is distinguished from "receipts," or total incoming cash within a period. The theory of accrual is that revenue, or gross income, may be recognized when its receipt in cash is sufficiently probable, and therefore not too far distant in the future, to be accurately estimated. The chief problem in developing accrual methods is that of deciding at what point in a firm's production process revenue is sufficiently certain to be granted recognition. In the case of trading concerns the solution is commonly to associate the sale with revenue recognition, so that periodic gross revenue becomes sales less prospective credit losses likely to arise from these sales. Needless to say, accountants, like economists, realize that not only sales, but all the processes of production, are considered to be productive, or revenue yielding. It is merely the recognition of this revenue which is made contingent upon the passage of title to completed output, and thus upon realization of a legal claim to cash enforceable against outsiders. The effect of associating revenue with a single step in the production process is to porduce a certain erratic tendency in periodic income figures in those businesses where the volume of inventories is unstable, although the volume of production may be fairly stable. For example, suppose the *X* Manufacturing Co. completes the same volume of physical output in both periods

1 and 2, but sales are greater in period 1 than in 2, with the result that a larger portion of the second period's output is in inventory at the close of the period than was the case at the end of period one. Usual accounting practice would assign the larger gross revenue to the former of the two periods. Although this may not be the ideal treatment in pure economic theory, in view of our assumption about similar physical outputs in the two periods, it is virtually the only one generally sanctioned by present accounting practice. It is notable that perhaps the most logical procedure of income recognition from the standpoint of economic analysis is to be found in the case of long term construction contracts, where revenue is sometimes accrued to parallel the progress of the construction work. Although this case is considered by most accountants as exceptional, it illustrates a very close correspondence between the economist's view of the origin of income and the accountant's view of income recognition.

Accrual methods for the handling of costs should, of course, harmonize with those which operate on the side of revenue. Since the revenue of any period is the amount of gross income in current dollars probably realizable in the normal course of events from production (usually defined in terms of a critical point such as the sale) the objective is to match with that revenue all of the explicit costs incident to the stream of output which is regarded as revenue-yielding for the period. Although this objective is logically simple, the practical difficulties in the way of securing a perfect periodic synchronization of revenue and expense recognition are very great.

THE CONCEPT OF COST

In economics the modern conception of cost is that "costs are a reflection of the value of the alternatives which are displaced in order that goods . . . may be produced."[21] In other words costs, in general, are dependent on valuations rather than being determinants of value,[22] although in the case of particular goods (replacement) costs may be regarded as partial determinants of relative values. Choices are the objective data which determine valuations and costs are the reflection of this basically subjective valuation process. All economic resources are valued in light of their potential alternative employments, so that when committed to a particular employment, the cost of that committment is the value of the alternative opportunities sacrificed. This concept of cost may be readily carried over into accounting theory with but slight modification.

Any business firm carries on its operations with the aid of a heterogeneous mass of equipment. I use the term "equipment" here, and elsewhere, in a generic sense to denote all economic resources to which the firm has rights, i.e., assets.[23] Cost is incurred when this equipment is dedicated to a particular function, and the amount of the cost is measured by the alternative opportunities sacrificed at this time. To illustrate, let us imagine a firm to begin business with its equipment consisting solely of cash. Cost, in the accounting sense, is incurred when part of this cash is exchanged for raw materials, or when a binding contract to this effect is negotiated. Costs, in the economic sense, or as accountants would prefer to put it, expenses are incurred when these raw materials are used to produce finished output. Expenses

[21] L. Robbins, "Certain Aspects of the Theory of Costs," *Economic Journal*, March, 1934, p. 6.

[22] Pre-Austrian economic analysis reversed this process of causation by considering sacrifices the objective data which determined costs, which in turn were reflected in the values of goods and services.

[23] This usage, though perhaps not in accord with standard current terminology, is convenient. Precedent for it may be found in J. M. Keynes, *The General Theory of Employment, Interest, and Money*, New York, Harcourt Brace, 1936, p. 52 ff.

are thus those costs which are identified with particular streams of current output as distinct from those costs (deferred charges) which will normally be identified with future streams of output. Costs which cannot logically be identified with any output, either past, present, or future, are called "losses."[24] Although the economist's conception of cost may be thus translated for accounting it is important to notice that the "costs" defined are costs of replacement and not expenses of record.

It is possible to represent the accountant as following the classical economic theory of valuation because he generally takes the view that cost is the proper basis of asset valuation for balance-sheet purposes, rather than regarding these values as summations of present prospective earning power, or stating them in terms of immediate replacement prices. This view, however, would be erroneous for several reasons. In the first place, original cost for accounting purposes is always an expression of the price at which an item of equipment was acquired, while the Ricardian economist conceived of this cost as the (subjective) sacrifices involved in the acquisition of the equipment. In the second place, historical cost, in accounting practice, establishes only the nominal value of a balance-sheet asset, and not necessarily the economic value of the equipment, which depends on potential earnings and on replacement prices. The accounting cost is derived from a market valuation, the price of the equipment in question. Prices are simply objective expressions of the balancing of subjective valuations in any exchange process. In the market subjective preferences give rise to objective choices, which in turn determine objective prices;[25] these prices are taken by the accountant as expressions of cost. Thus, in the case of the aggregate of goods and services, cost is basically determined by valuation, rather than being a determinant of valuation. Finally, the accountant frequently employs other methods of valuation aside from original cost. There is, then, no reason to associate accounting theory with classical economic analysis, and there need be no fundamental conflict, with respect to cost, between accounting practice in the broadest sense and economic theory. I will return to this point again in part three.

DEPRECIATION ACCOUNTING

It is characteristic of many types of business equipment to be capable of repeated use in the process of production. The problem of depreciation accounting is that of assigning the original cost of this type of equipment to the outputs of successive fiscal periods in such a fashion that the recorded cost of the equipment will be exactly prorated over its total service life. Depreciation accounting also serves two incidental purposes: that of giving an approximation of the present value of equipment at points intermediate to its life span, and that of maintaining intact the "value" of a firm's equipment, figured generally on an original cost basis, by providing for the recovery of depreciation cost from gross revenue.[26] A third incidental function, that of providing funds for the replacement of obsolete equipment, is

[24] A more usual definition of a loss is "any subtraction from equities resulting from expiration of some asset value for which no compensation whatever is realized." Cf. W. A. Paton, *Accounting*, 1924, p. 137. This amounts virtually to saying that the expiration of value, or cost, cannot be identified with any revenue, nor with any stream of output yielding revenue. Losses on particular assets must be distinguished, of course, from losses in the sense of negative net income for a business period. The above definition applies only to losses on particular assets.

[25] The details of this process of price determination, which forms the basic part of economic theory, need not be reproduced here. A detailed and precise statement of this type of analysis may be found in J. R. Hicks, *Value and Capital*, London, 1939, pp. 11–110.

[26] Correct depreciation accounting alone will not insure maintenance of the value of equipment unless gross revenue is adequate to cover all depreciation, and other, charges.

sometimes erroneously attributed to depreciation accounting.

The primary, or cost spreading function of depreciation recording requires that accurate estimates be made of the prospective service life of equipment for the purposes of determining and revising depreciation rates. Service life is limited by obsolescence and by physical deterioration. The former is a function of changes in the techniques of production associated with elapsed time. The latter is primarily a function of the volume of production. Ordinary accounting practice commonly uses over-all rates for the estimation of combined depreciation and obsolescence. The effect of this practice in the case of firms whose outputs fluctuate appreciably is thus to make periodic depreciation charges less dependent on the scale of operations than they should in some cases be, since the same charge is made in periods of subnormal as in periods of supernormal activity. Separation of the obsolescence charge and the development of depreciation methods based on service output would help to offset this effect. The reason for making this separation is that depreciation associated with use is a prime cost of production, whereas the obsolescence charge is not. Where over-all rates are used the result may thus be to overstate the supplementary costs in slack periods, and to understate them in peak periods. This in turn, may produce an apparently erratic tendency in the reported income figures of firms in this position.[27]

Insofar as income fluctuations are the result of rigid allocations of cost rather than lack of flexibility in the costs themselves, it would seem clear that accounting practice should develop methods to correct this distortion, thus possibly smoothing the reported income figures of firms subject to cyclical fluctuations, and giving more accurate expression to true production costs in periods of non-normal operation.

PRIME AND SUPPLEMENTARY COSTS

Since accounting reports, together with market analyses, are the basic information on which management draws in the formation of price policy, accounting practice might helpfully yield a clear separation of prime and supplementary costs. Prime costs are those which fluctuate directly with, though not necessarily in proportion to, the volume of business, while supplementary costs are independent of the volume of business, while supplementary costs are independent of the volume of current output.[28] This distinction does not parallel, as is sometimes erroneously assumed, the accounting dichotomy of direct and overhead costs, which is based not on the relation between cost and output, but on the problem of tracing lumps of cost to units of finished product. In the words of one writer "burden or overhead is the term commonly applied to those expenses, expirations, and accruals which cannot be traced directly, or with the same degree of certainty into the manufactured product as can the direct labor and materials.[29] Among the many methods developed by cost accountants for distributing overhead

[27] J. B. Canning has called attention to this effect, which he feels to be a fairly general result of current accounting practice. Cf. "Accountants' Income Procedure," *Econometrica*, 1933, pp. 52–57. A very careful, detailed analysis of the effect of straight-line depreciation methods of different firms may be found in an article by O. Nielson, "Depreciation as a Function of Revenue," ACCOUNTING REVIEW, September, 1938, pp. 265–275.

[28] A more accurate definition of supplementary cost is that it is total cost associated with a zero rate of current output. All other costs are prime. Cf. G. D. A. MacDougall, "The Definition of Prime and Supplementary Costs," *Economic Journal*, September, 1936, pp. 443–461. A basic difficulty in this definition is that supplementary costs vary with the length of time a zero rate of output is expected to continue. For a going concern, then, we define supplementary cost as the cost of zero output in the case where production is expected to be resumed momentarily.

[29] M. B. Cogburn, "Burden Application," *Journal of Accountancy*, March, 1938, p. 208.

in calculating unit costs, the most logical seem to be those which endeavor to make a clear separation between the prime and supplementary portions of the indirect, or non-traceable items.[30] For example, in a business with four production departments and two service departments it might be preferable not to distribute the entire cost of operating the service departments to the production departments on the basis of floor space, machine hours, units of output or other arbitrary methods. Instead, costs of the service departments might be analyzed to determine whether or not they fluctuate with the volume of finished output of production departments, and thus might be broken down into prime and supplementary classes. Prime costs in the service departments may then be distributed upon an actual output basis, while supplementary costs may be distributed in some other way. If it be found, upon analysis, that service department supplementary costs result largely from the necessity of maintaining fixed equipment and personnel it would perhaps be more logical to prorate these costs over the production departments not on an actual output basis, but on the basis of peak or maximum use of service department facilities. For clearly it is maximum use by production departments which dictates the size and character of service departments and thus the amount of service department supplementary costs.

The effect of thus preserving as sharp a line as possible between prime and supplementary costs would be to add greater flexibility to the unit cost figures by eliminating arbitrary allocations of overhead except in cases where true supplementary cost, not a function of output, is involved. Management could then be given unit prime cost figures as well as unit total costs and the additional information might be very helpful, particularly in slack periods when new business at prices sufficient to cover total unit costs might not be forthcoming. At such a time accurate prime cost figures would be of great value in mapping out future sales and price policy. It is even possible that with such information some firms might be induced to adopt a more flexible price policy than that formerly followed.

Where predetermined cost systems are in use, one of the advantages claimed is that this type of cost accumulation enables the attention of management to be concentrated on the causes of, and responsibility for, the variances between actual and standard cost, with the result that greater efficiency is secured. The disposition ultimately made in the accounts of these variances obviously depends on the type of standard in use. Standards may be drawn either in terms of ideal levels of ultimate achievement, or in terms of actually expected and normally realizable performance. Inasmuch as one purpose of the variance analysis is to call the attention of management to preventable unfavorable variations, it is desirable to follow the separation of prime and supplementary cost in this analysis. Variances between actual and normal supplementary costs will be found, in most cases, to be associated with an abnormal volume of operations or with other influences not subject to a high degree of direct control by the management.[31] On the other hand, the residual or prime cost variances are, to a

[30] D. D. Kennedy has reported that the coefficients of variation for overhead costs in relation to hours worked ranged from −.41 to +.99 in a typical machine shop. The negative variations were a result of changing the miscellaneous expense classification. These figures show plainly that overhead and supplementary costs are not synonymous. Cf. "Variability of Overhead Cost," *Journal of Accountancy*, March, 1930, pp. 206–208.

[31] J. Dean has reported a significant correlation between all cost variations and such factors as volume of output, average size of production order, and frequency of changes in styles. Cf. "Correlation Analysis of Cost Variations," ACCOUNTING REVIEW, March, 1937, pp. 55–60.

higher degree, subject to correction, and the attention of production executives may rightly be centered on these items where gains in efficiency may be reasonably expected to result form more scientific supervision. Thus some separation of prime and supplementary cost proves to be an indispensable aid in executive control.

The use of flexible predetermined costs, controlled by a flexible operating budget, is also an attempt to isolate controllable cost variations. In most cases the flexibility of the standards is a result chiefly of prorating the expected overhead costs over varying levels of prospective output. If prime and supplementary costs are segregated by analysis, it may appear that some flexibility is needed for direct costs and that quite different degrees of flexibility are required by different overhead cost items. In other words, both direct and overhead costs may be found to be composed partly of prime and partly of supplementary cost. In this fashion more accurate standards may be developed with a resulting decrease in variation and consequent simplification of the task of supervision.

MATCHING COSTS AND REVENUE

The objective of income accounting is to secure the best possible synchronization of periodic revenue and cost recognition by the development of parallel accrual methods. The fineness of the allocation techniques required is dependent chiefly on two factors, namely, the degree of instability of physical output volume, and the shortness of the accounting period. Where the output of a firm is fairly constant from period to period, rough methods of allocation for revenue and cost may be used without great distortion appearing in the resulting income figures. But in those industries where output fluctuations are appreciable, accurate income figures can be obtained only by a careful separate allocation of prime and supplementary cost on a basis to parallel the methods used for recognition of revenue. Likewise, where the accounting period is fairly long (a year or more), less accurate methods of accrual are required. Revenue may be defined so as to more nearly equal "receipts" and expenses may approximate "expenditure." But as the accounting period is made shorter, many expenditures, charges, and expirations must be spread over more than one period. Equalization reserves may be used to bring about an appropriate distribution of bulky items of expense, thus offsetting the random incidence of such things as major repairs to equipment, and extraordinary appropriations for advertising, etc. In general better accrual techniques and allocation methods must be developed for short accounting periods if the reported income figures for successive periods are to be consistent, and free from erratic influences traceable to accounting procedure.

III

The chief point at which there appears to be a real conflict between the accountant's conception of cost (expense) and that of the economist is in connection with the original versus replacement cost controversy. Since the economist sees costs as the values of displaced alternatives, he logically adopts the point of view that the current cost of using an item of finished equipment is the present value of the alternative opportunities for using it in the future which are displaced by use of the equipment in connection with current output. This present value is, of course, calculated by capitalizing the expected values of prospective future employment of the equipment on future output. The calculation is thus dependent, among other things, upon anticipated future prices for finished output,[32] as, in general, any cap-

[32] Cf. J. M. Keynes, *The General Theory*, 1936, especially the "Appendix on User Cost," p. 70 ff.

italization process implies some definite set of expectations of relevant future conditions. Capitalization, and cost based on capitalization, are thus basically subjective magnitudes. In searching for an objective basis for cost which is in conformity with his value theory, the economist is thus led to replacement of service cost as an approximation of the present (capitalized) value of equipment. The assumption involved in this approximation is that replacement cost and the present value of expected future services are equal. This assumption is, in general, fulfilled[33] since equipment prices are themselves determined, at least in part, by demand, which is based upon capitalization. Thus replacement cost is the logical objective counterpart of subjective valuation by capitalization.

REPLACEMENT COSTS IN ACCOUNTING

On the other hand, there is a real reluctance among accountants, particularly among those more concerned with the preparation of financial statements than among those chiefly engaged in compiling cost statistics, about employing replacement cost techniques in accounting work. Some of this resistance is attributable to the feeling that original cost figures are definite facts, whereas replacement costs are merely tentative estimates, subject to constant change, and to the whims of the estimators. As one writer puts it, "I do not deem it to be the function of accounting to jumble up the prognostications of the forecasters with the known facts of past and present."[34] This objection has weight chiefly with respect to those assets which, by virtue of their specificity to the firm, cannot be compared with identical equipment having a definitely established price in an organized market. Partially depreciated fixed assets are a case in point, replacement of service cost in this connection being largely a matter of appraisal.

A second objection often made by accountants to replacement cost methods of valuation is that these methods place primary emphasis not upon the allocation of costs, or accounting for capital originally invested, but upon "maintenance of capital" and the accumulation of funds for the financing of replacements. In the discussion of depreciation above, it was argued that these sinking-fund functions are, at most, incidental in ordinary depreciation accounting. It is now essential to examine these ideas in somewhat greater detail.

At the time equipment is acquired, original and replacement cost are, of course, identical. Any discrepancy which later develops must be due either to the use of depreciation rates which do not reflect the true portion of the total services of the equipment consumed during a period, to changes in the technique of production, or to changes in prices. These price changes may be either specific to the equipment in question, or they may be general price changes, associated with some disturbance of monetary equilibrium. When prices are rising replacement cost will tend to exceed original cost, and when prices are falling replacement cost will tend to fall short of original cost. In other words, if we compare income, when defined as revenue less expenses based on original cost, with "income" defined as revenue less expenses derived from replacement cost, which I shall call "corrected income," we find that "income" exceeds "corrected income" in periods of rising prices, and that the contrary prevails in periods of falling prices. Advocates of replacement cost contend

[33] Exceptions must be made for the case of nonreplaceable goods and services and also in cases where replacement is not immediately possible, in which cases a difference between capitalized value and replacement cost may exist subject to a change in the supply of the equipment in question.

[34] W. M. Cole, "Theories of Cost," ACCOUNTING REVIEW, March, 1936, p. 9.

that a part of what is called "income" when depreciation is figured on original cost is in reality "capital appreciation" and thus that accounting practice which regards depreciation only as a process of allocation of original cost has failed to fulfill one of its primary functions, namely to distinguish clearly between income and capital.[35] By overstating income, in periods of rising prices, the argument continues, conventional accounting fails to maintain intact the real significance of invested capital, and is content with a purely nominal maintenance instead.

INDEX NUMBERS IN ACCOUNTING

When a firm reports as "income" for a period the difference between revenue and historical cost, this income proves, upon analysis, to be the net resultant of two dissimilar factors. The first part of the income, in some cases the whole of it, is the earnings of menagerially sponsored and controlled activities, such as buying, processing, selling and the like. The second part of the reported income is the result of price changes, either changes specific to the types of equipment associated with the firm, or more general price movements.[36] The contention of the advocates of stabilized accounting is that these two essentially dissimilar components of what traditional accounting calls "income" should be separated. The philosophy of stabilization holds further that income, as reported by usual accounting methods, requires correction for the effects of these price changes, which are in general beyond the control of the firm, and which are reflected not as "income" but as capital gains and losses.[37] For the purpose of making corrections for general price changes, stabilized accounting recommends the use of general price index numbers. When accounts are corrected by the use of these index numbers, the argument continues, the resulting "real income" will include all capital appreciation and depreciation resulting from current general price changes, regardless of whether this appreciation (depreciation) is currently "realized" or not. If stabilization is coupled with the use of replacement costs, this capital appreciation and depreciation may then be broken into aggregate appreciation (depreciation) resulting from all price changes, and particular appreciation (depreciation) resulting from price changes which are specific to particular classes of equipment. Appreciation or depreciation which results from price changes may be distributed in any fashion between "realized" and unrealized portions, but nevertheless it is attributable to the period in question. Hence the characteristic of stabilization is a break with the usual "realization" test for the recognition of capital gains and losses.

One of the chief criticisms which may be made of stabilized accounting is that it is impossible to separate completely general from specific price changes. One of the most important limitations involved in the use of index numbers stems from the fact that these numbers, being statistical averages, give no information regarding the disperison of the data from which they are drawn. In the case of price indices, therefore, attention is centered upon the

[35] An extended treatment of this argument is given by H. W. Sweeney in an article entitled "Stabilized Depreciation," ACCOUNTING REVIEW, September, 1931, pp. 165–178; cf. also his book, *Stabilized Accounting*, New York, 1936.

[36] A similar analysis of the components of income is given by D. K. Griffith, "Weaknesses of Index Number Accounting," ACCOUNTING REVIEW, June, 1937, p. 128.

[37] In the words of F. Schmidt, "Differences in value between original costs (*Selbkosten*) and current replacement costs (*Ersatzkosten*) have the character of value changes in capital, conditioned by changing current market prices for production goods. Therefore they logically belong to the accounting for capital and not in the accounting for operations." *Die Organishe Tageswertbilanz*, Berlin, 1929, p. 124; cf. also "Is Appreciation Profit?" ACCOUNTING REVIEW, December, 1931, pp. 289–293.

behavior of a hypothetical general price level, while no information is given about the behavior of secondary or sectional price levels. Economists are, in most cases, fully aware of the dangers involved in working with the concept of a general price level and thus implicitly assuming that the dispersion of secondary price levels about this general level is uniform over any period of time. Mr. Keynes has made the point plainly by writing that "it is much safer to keep our minds alive to the plurality of secondary price levels and the separate influences which determine their movements in relation to general purchasing power, rather than to regard any divergence of particular price levels from uniformity as a temporary abnormality which will soon cure itself.[38]

On the other hand, if one recognizes the plurality of price levels, and the concern of most business men with economic conditions, not in general, but primarily in their own industries, there would seem to be reason for suggesting that, not maintenance of general purchasing power, but maintenance of purchasing power in light of the use to which this purchasing power will normally be put, is the desirable objective. This latter view would, of course, substitute for the general index numbers, special indices of secondary price levels which are of particular interest to the firm. The object would then be, not to maintain the ability of the firm to replace its equipment by drawing a random sample of all goods and services, but to maintain the ability of the firm to purchase the type of products it will normally require for its prospective operations. This latter concept of "capital maintenance" thus appears to be one of particular interest to management. To achieve maintenance in this sense a wholesaling firm would build its stabilization techniques on wholesale price indices exclusively, while a firm manufacturing metal products, for example, might use some price series peculiar to that industry.

Although stabilization originally grew out of a desire to avoid undermaintenance of capital during periods of rapidly rising prices, use of its methods, not in place of, but in conjunction with, the historical cost methods of accounting, has the important derivative result of permitting a better analysis of the reasons for the size of reported income, as well as achieving what some believe is a more logical distribution of income between accounting periods, than could be obtained without the stabilization technique. By making possible a workable, if not ideal, separation of the effects of price changes on capital and income, and the effects of normal converting and processing activities on financial position, better executive control may be secured through concentration upon the controllable determinants of income variation. Stabilization is thus seen to be not so much a change in accounting methods as an expansion of them. According to this view, the stabilized statements do not replace the customary financial statements, but become statistical adjuncts. As such they are intended primarily for managerial purposes, but may be informative also, in certain cases, for creditors, stockholders, and other groups with equities in the firm. How far the stabilization process should be carried by a single firm depends largely on the extent to which it is subject to price fluctuations and the degree of these changes. The extent to which the supplementary stabilized statements should be made available to those outside the management depends on the degree to which customary financial statements are less misleading than they would be if supplemented.

[38] J. M. Keynes, *A Treatise on Money*, 1930, Vol. I, pp. 93–94.

REPLACEMENT COST APPLIED TO INVENTORIES

That the concept of replacement cost is finding acceptance in accounting practice is well illustrated by its increasingly widespread use in the valuation of inventories. Application either of the base stock method of inventory reserves[39] has the effect of producing a long range view of income, which view removes much of the erratic effect of cyclical price changes from the periodic income figures. These methods, however, mean an acceptance of replacement cost only in connection with the valuation of a particular class of asset, and as such have the somewhat undesirable result of producing financial statements which are a mixture of valuation methods. So long as accounting practice follows the policy of producing a single set of general purpose financial statements, such composites of heterogeneous valuations are probably inevitable. In theory the case for separate parallel statements, each incorporating but a single principle of valuation, seems clear; in practice, however, such academic distinctions are seldom preserved. Instead the management of each firm selects whatever part of the theoretically ideal methods it feels worth while in light of the special problems of its field.

INTEREST ON PROPRIETARY CAPITAL

A second point at which accounting and economic conceptions of cost clash is in connection with interest on proprietary capital. Conventional accounting practice regards this, formally at least, as a distribution of net income rather than a cost of obtaining net income, while economists are in virtual unanimous agreement that interest is a production cost. Elimination of interest on proprietary capital in financial accounting produces a systematic understatement of cost and overstatement of income. But one should not be misled into thinking that this omission has any very great general effect on price policy, for many cost accountants recognize the necessity for including interest in unit cost statistics, and most businessmen base prices on unit costs plus "normal profit,"[40] which includes an allowance for interest, risks, managerial services not explicitly compensated, *etc.*

The chief point in criticism of omission of interest on proprietary capital from accounting is that this omission makes more difficult a clear separation of prime and supplementary cost. For while interest on "fixed capital," (capital invested in long lived equipment) is clearly a supplementary cost, interest on "circulating capital," (capital invested in equipment which must be replaced each production cycle), is, at least in part, a function of output and thus, to some extent, a component of prime cost.[41] Insofar, then, as a clean separation of prime and supplementary cost is desirable in effective cost accounting, interest on proprietary capital should have a place in the unit cost figures if not necessarily in the financial statements.

MAINTENANCE OF CAPITAL

Among economists there is no general agreement as to what exactly is implied when the term "maintenance of capital" is used. Views range all the way from the pessimistic conclusion that "the concept

[39] Cf. C. B. Nickerson, "Inventory Reserves as an Element of Inventory Policy," ACCOUNTING REVIEW, December, 1937, pp. 345–354.

[40] Economists define "normal profit" in terms of a level "at which there is no tendency for new firms to enter the trade or old firms to disappear out of it." Thus the level of "profit" which is normal to any firm is functionally related to the degree to which the firm is immune to potential competition. Cf. Joan Robinson, *The Economics of Imperfect Competition*, London, Macmillan, 1933, p. 92.

[41] The point is that less circulating capital is required for a zero rate of output than for a positive rate. Since supplementary costs are those associated with zero output, they do not include interest on capital required when output is above zero. Cf. F. Machlup, "Interest as Cost Factor and as Capitalization Factor," *American Economic Review*, September, 1935, pp. 459–460.

of maintenance of capital has no definite meaning"[42] to the view that capital is maintained when the aggregate money value of capital goods, divided by an appropriate index number of general prices, remains constant.[43] Undoubtedly the chief reason for the lack of agreement as to the meaning of capital maintenance lies in the fact that the term has been used by various writers in many different senses, of which the following is a partial list:

1. Maintenance of a constant quantity of physical equipment;
2. Maintenance of a constant quantity of physical equipment at a given level of technical efficiency;
3. Maintenance of a quantity of equipment capable of producing a constant stream of physical output, either at
   (a) the "normal" rate of operation
   (b) a capacity rate of operation;
4. Maintenance of a collection of assets equal in "value" to the original cost of long lived equipment.
5. Maintenance of a plant capable of earning a constant stream of money income when operating either at
   (a) the normal proportion of capacity
   (b) the actual proportion of capacity;
6. Maintenance of equipment expected to earn a constant[44] stream of "real income" after providing for corrections due to price changes;
7. Maintenance of a constant proportion of all the assets of the economic system.

As may readily be seen, the many senses of "capital maintenance" result in part from use of the term both in connection with physical goods and with valuations. If one adopts the valuation view of capital it is probable that definition 6 would come closest to representing a consensus of viewpoints.[45] It is interesting to notice the correspondence between this definition and that adopted by the advocates of stabilized accounting.

The purpose of capital maintenance is to enable persons or firms to have perpetual access to a given amount of deflated income, which roughly represents a given quantity of goods and services and thus some certain "quantity" of psychic income. This conception of maintenance also has the merit of consistency with the idea of capital as the value of all claims to expected future income.

CAPITAL GAINS AND LOSSES

Since capital values represent claims to expected income, these values are dependent on expectations. We have seen that expectations are not always mutually consistent so that periodically they require revision in the light of past experience. This revision may apply either to the length of time equipment is expected to earn net income, the amount of the net income to be realized, or the rate of interest used for discounting. When expectations are revised, the resulting upward or downward revaluations of capital claims are known in economic analysis as "capital gains and losses." These gains and losses constitute corrections of "obtained income" in the sense that total income for the entire life of an economic unit is the algebraic sum of all periodic reported incomes plus all capital gains and minus all capital losses. These gains and losses are thus part of income if a long view is taken, although they are usually kept separate from periodic income because of the erratic effect that would be produced if they were lumped with the figures representing obtained income from normal sources.

The accountants' view of capital gains and losses differs from that just attributed to the economist in that accountants do not necessarily think of capital gain as the opposite of capital loss and *vice versa*. Capital gains are considered to arise outside

[42] F. A. Hayek, *Profits, Interest, and Investment*, London, Macmillan, 1939, p. 152.
[43] A. C. Pigou, *The Economics of Welfare*, 3rd Ed., London, Macmillan, 1929, pp. 45–47.
[44] Constant over a period of time generally taken long enough to exclude cyclical fluctuations.
[45] Excluding, of course, the legal view of capital maintenance.

the ordinary course of business activity and are recognized only upon "realization," that is, when equipment is sold. Capital losses, on the other hand, are not always regarded as "extraordinary" but are frequently seen merely as corrections of past expenses and are recognized by conservative practice as soon as they can be accurately foreseen.[46] Failure to attribute capital gains to the period in which they may logically be said to occur is due largely to a desire to maintain capital in the face of uncertainty rather than to any defect of accounting theory. The conservative understatement of income in some periods which results from this practice is later corrected, but the true incidence of changes in expectations upon valuations is distorted slightly.

CONCLUSION

This paper has endeavored to show that no unbridgeable gaps exist between the concept of income found in economic theory and those used by accountants. To be sure many minor differences are apparent, but these are mainly traceable to the particularism of accountants as compared with the social viewpoint of economists. Furthermore, the underlying harmony between the various conceptions of income is apparent only when one takes the broadest view of accounting, and regards it not as the art of preparing financial statements, but as the art of collecting and interpreting all economic facts which may be expressed, for the benefit of a firm, in money valuations.

Finally it is essential to see that there is no such thing as a single definition of "net income" or a single set of methods for measuring this quantity. In the final analysis "net income is not a precise entity given in nature. It is a portion of gross output selected and marked off from the rest by a boundary line, which our own choice, not objective fact, imposes."[47] The problem of defining and measuring income is the problem of reconciling the choices which cause this boundary line to be drawn in different ways.

The principles which guide accountants in drawing the net income boundary line have been summarized as follows:

1. "Income is an increase in wealth provided it be understood that it does not include an increase in wealth resulting from gift, appreciation (meaning thereby an increase in the market value of an asset or an increase in its cost of reproduction or replacement) or investment (as in the case of stockholders) contribution to the capital of a corporation."

2. "Income is the summation of increases (increments) and decreases (decrements) in wealth over a period of time."

3. "In the periodic summation an increment in wealth is to be recognized only as and when the business in question has become legally entitled thereto, without substantial restriction, in an amount reasonably determinable or measurable."

4. "In the periodic summation a decrement in wealth is to be recognized whenever the business in question (a) becomes legally obligated without offsetting assets, or (b) has utilized or consumed assets (depreciation, depletion, *etc.*) or (c) has lost or probably will lose, assets by any one of a variety of causes in each instance in an amount which can be measured or determined with reasonable accuracy."[48]

The principle which guides economists in the measurement of income is that of deducting from the value of current output "a certain sum, to represent that part of the value which has been (in some sense) inherited from the previous period."[49]

[46] Cf. K. L. Smith, "Capital Gains and Losses in Accounting," ACCOUNTING REVIEW, June, 1939, pp. 126–128.

[47] A. C. Pigou, "Net Income and Capital Depletion," *Economic Journal*, June, 1935, p. 240.

[48] J. L. Dohr, "Income Divorced from Reality," *Journal of Accountancy*, December, 1938, pp. 362–336.

[49] J. M. Keynes, *The General Theory*, 1936, p. 52.

In the main the differences between the net income boundary lines drawn by accountants and economists may be said to result from:

1. Differences regarding the functional relationship between physical output and the recognition of gross revenus;
2. Differences as to the relative importance to be assigned to original and to replacement costs;
3. Differences in the treatment of capital gains and losses;
4. Differences in point of view as to the proper horizon of expectations which should be reflected in current income figures. If these differences are borne in mind adjustment of any of the main income concepts of economics or accounting to the remaining ones presents no insoluble problem. It is important, however, to see clearly each step in passing from the income concept of modern economic theory to those recognized in accounting practice. When the precise nature of the required adjustments is made plain to both economists and accountants, economic analysis and accounting practice should gain equally in clarity and logical alliance.

COST ACCOUNTING IN GERMANY

A. Matz

In the June issue of the Accounting Review, the defined principles and objectives of German accounting, together with a uniform accounting plan were presented by the author. The Board of Industrial Economy (Reichsausschuss für Betriebswirtschaft, RfB) has continued its work with regard to improvement in all fields of accounting by publishing on the 16th of January, 1939, its "General Principles of Cost Accounting."[1] The following presentation is based chiefly upon the report of the Board.

The purpose of these "General Principles of Cost Accounting" is to assist in achieving increased economy in production, for it is believed that a cost-accounting system based upon these principles will lead to a correct ascertainment and clear conception of all costs involved. Such a system will promote cost supervision, estimate, price determination and cost comparison within the plant or within the industrial group. All these steps will contribute to the final goal: increased economy and greater performance in business and industry.

These principles do not attempt to stifle the cost methods as they exist at present in many industries but are considered the minimum requirements of purposive cost accounting. The hope is expressed that those industries and businesses which are now beginning to set up a new or better system will avoid any schematic or cut-and-dried methods. In larger industries the development may lead to improvement; in smaller ones to a simplification of the procedure.

The letter which accompanied the decree when it was sent by the Minister of Economy to the chief industrial and business groups is of interest. It states "that these 'principles of cost accounting' are of importance to German industry which has to fulfill such great tasks under the Four-Year Plan. The performance of a business is definitely determined by its costs. Their clear-cut construction which aims for the greatest possible economy presupposes clarity concerning type as well

[1] RKW Mitteilungen Herausgegeben vom Reichskuratorium für Wirtschaftlichkeit, "Allgemeine Grundsätze der Kostenrechnung," January, 1939, Beuth-Vertrieb, Berlin.

as the amount and origin of all costs. This clarity of costs can be attained only through a thorough and exact cost accounting which is the prerequisite for every phase of business.

"The influence which a profound knowledge of costs will have upon the formation of prices within an enterprise must furthermore result in cleaner conduct among competitors. The spread and extension of cost-accounting methods in industry and business may therefore eliminate business connections or ties arising as a result of quotations based on erroneous costs.

"It is once more emphasized that these principles merely concern cost accounting, not price calculation. Directions which serve in determining the selling price may not be issued by the industrial groups.

"The last great goal of reform in accounting is the intercompany exchange of experiences and results thereof within an industrial group or trade association. This aim necessitates uniform cost accounting in all industries."[2]

GENERAL PRINCIPLES OF COST ACCOUNTING[3]

I. Purpose of the principles:

To increase the economy of performance in industry. They form the basis for cost accounting methods of the various organized groups within the national economy.

II. Nature and Tasks of a Cost-Accounting System.

A. The economy of performance depends upon the economy of costs, the prerequisite, therefore, is a correct knowledge of costs.

B. Correct cost accounting means an exact integration and calculation of all costs. Costs are the evaluated use of goods and services rendered. Therefore in a cost computation, the economic consumption is the deciding factor rather than the expenditures.

C. Uniform and thereby comparable cost accounting is necessary in order to be able to compare present results with previous ones and with those of other companies of the same industry.

D. If a cost-accounting system is based upon these principles it will make possible the following:
1. Cost supervision
2. Estimate
3. Preparation for the calculation of individual performances or groups of performances.
4. Comparison within the enterprise as well as with others.
5. Execution of other tasks such as: to evaluate inventories, and self-constructed fixed assets; to render a basis for the monthly income statement, for statistics, and for the budget.

E. All divisions of accounting are closely interwoven with cost accounting. Through the interlocking with other branches of accounting, cost accounting receives greater recognition and more accurate verification. The figures of cost accounting come from the general bookkeeping system, or they are at least based upon it; statistics evaluate the results of cost calculation, and the cost figures are again used in the construction of a budget.

III. Construction of a Cost-Accounting System.

A. General Rules:

The general directions compiled by the group or trade association must be adjusted according to the size of the business which is representative in the particular industry. Therefore, the organized groups of all industries and businesses are requested

[2] RKW Mitteilungen, p. 3.

[3] *Ibid.*, p. 4. (The summary that follows is a free translation or interpretation of the German text.)

to issue special rules or supplements depending entirely upon the size or type of business. These directions must contain the following minimum requirements in order to fulfill the tasks of cost accounting:

1. Cost accounting must be exact. In particular, costs must be allotted to the proper period of usage.
2. All figures of the cost system must be based upon business papers and should be comparable with general books, statistics and budget.
3. The cost-accounting system must be patterned to suit the size of the business, the production process and type of output.
4. The figures of cost accounting must be as nearly comparable as possible with regard to time periods, production methods, actual and estimated output.
5. The system must be synoptic and must offer quick results.
6. Construction or extension of the cost system must remain within the financial means of the enterprise.

B. Basic Forms of a Cost System

For the attainment of the goals of cost accounting, all costs should be absorbed and grouped according to classes (wages, material, depreciation), burden centers (origin, function, responsibility), and units marketable production and items produced or constructed for the company's own use).

C. Integration of Costs.

1. Exact integration of all costs forms the deciding basis of correct cost accounting.
2. The integration of costs does not only refer to values, but also, as far as possible, to quantity and periods. Quantitative integration can be achieved by the inventory method or by a computation based upon actual consumption in production. However, the most exact method is the perpetual-inventory system. In order to provide for the quantitative and monetary calculation of material, wages, and capital assets it is necessary to establish a well-organized business which provides preparation and supervision of the work, i.e. an order department, stock-room control, etc., as well as purposeful methods with regard to business papers (i.e. piece and wage tickets, control of material, and facilitative records for fixed assets).
3. The rules relative to the fiscal period are to be observed in the cost calculation (i.e. wages for vacation, insurance, and repair costs.)
4. Extraordinary expense and income items are not to be taken into account for cost purposes. If the cost calculation is made the basis for price calculation, the legal decrees must be consulted with regard to the fixation of prices. This is particularly important in connection with expenses which must be met out of profit.
5. Unless certain objectives of the cost system require a different method, it is possible to include an estimated salary for the enterpriser and an estimated "risk" figure. In place of depreciation figures for balance-sheet purposes, the cost calculation should contain depreciation which has been determined according to definite rules. Instead of considering interest as part of the profit, certain requirements may necessitate the addition of a specific amount as

interest on the entire investment. The actual expenses, as well as any estimated figures, must definitely be recorded in the general books.

With regard to the inclusion of estimated costs such as a salary for the enterpriser, "risk," depreciation, and interest, the following points should be observed:

a. Individual businesses and partnerships may include a reasonable salary for the owners as well as for all those members of their family which are employed on a nonsalary basis. The amount is considered reasonable, if it corresponds with the average salary of an employee in a similar position.

b. An estimated amount for risks (i.e. for guarantees) is a kind of self-insurance. Directions issued by an industrial group should explain this phase further. The general risk of the enterprise is ***not*** a part of the cost.

c. As a rule, only depreciation in the value of those fixed assets that are actually needed and used in the production process may be considered as a cost. Depreciation computed for balance-sheet or taxation purposes upon a different basis should not be used for cost calculation. Only such fixed assets are considered necessary for the operation of the business as are continuously employed in production. Depreciation is to be computed on the cost value of the fixed asset or, in want of such, on the basis of a present-day appraised value with due consideration for the expected life of the asset. In order to establish the useful life of the asset, technical depreciation based upon past experience is to be observed. Yet special economic conditions such as expected market changes or technical developments, may cause a shortening of their use. On the basis of the useful life of assets, their rates of depreciation are to be determined in the various industries. Should it become obvious that the first established rate was miscalculated because of recent experiences, a correction of the rate is desirable. In order to offer a basis for the correct calculation of the depreciation used for cost purposes, ***all*** fixed-asset records must be kept in an individual file or index card system. These plant records must contain, in addition to technical information, all other statements pertaining to the calculation of depreciation. Expenditures which tend to increase the value of the asset are first capitalized and later depreciated according to the above rules. A direct allocation of depreciation is desired wherever possible.

d. With respect to the inclusion of interest on the total capital necessary for the operation of the business, the following suggestions are to be followed: Capital necessary for the operation of the business is understood to be the value of such parts of the fixed and current assets which are continuously employed in the industry. Among the items ***not*** to be in-

cluded are: capital assets which do not enter into production, such as land not used directly in production; abandoned assets; the value of homes and investments which do not serve for the attainment of the industry's goal; securities and bank accounts, unless they represent short term investments of surplus cash. The value of the capital assets needed for the operation of the business should be reduced by the amount of such capital which was placed at the enterpriser's disposal free of interest charges as a result of the terms of payment (accounts payable) or through the down payment of customers' accounts or through a loan. To compute the interest, fixed assets are to be taken with that book value whose depreciation charge was used for cost purposes, whereas the working capital should be stated on the basis of an average figure for the period. The individual firms should employ uniform interest rate, unless the special purposes of the cost calculation require a different method. The distribution of this interest cost among the burden centers and units takes place according to those capital amounts which are positively tied up in the business.

6. The companies may set their own basis of valuation. Observing the legal regulations, they must follow generally adopted accounting principles. Companies may use: the purchase price or replacement cost, cost or market price, individual or average price, as well as estimated prices. If possible, the price f.o.b. consignee is to be used for valuation purposes. Rebates and discounts must definitely be deducted. Yet uniform valuation is necessary in order to execute intercompany cost comparsons and arrive at comparable results.

D. Accounting for Costs.
   1. Cost accounting comprises two methods:
      a. Direct cost accounting which immediately distributes all costs among the burden centers and units.
      b. Indirect cost accounting in which distribution takes place with the aid of symbols.

      The individual costs correspond to direct cost accounting, and the general or fixed costs to the indirect method. Exact cost accounting requires the greatest possible direct distribution of all costs among the burden centers and units.
   2. The method and means of ascertainment and of distribution of costs for the individual product are largely determined by the type of goods produced. The following groups of cost allocation methods are to be distinguished:
      a. The purely divisional method (process cost system) is applicable only to a uniform performance in the entire plant or in one of its departments. This method collects the costs of one period for all the units produced. The unit cost is ascertained by dividing the total cost figure by the number of units produced.
      b. One variety of the production order system is the "Aequivalenzzifferrechnung," a method

which presupposes several performances with related costs. By the use of standards which were either arbitrarily fixed or obtained by experience, it will be possible to convert the various units of performance into similar types in order to apply the process cost system as discussed in part a.

c. The "Zuschlagsrechnung" which is employed in the event of several kinds of production, distinguishes between individual or direct and common or indirect costs. Its characteristic feature is the direct allocation of individual or direct costs upon the unit and the indirect allocation of manufacturing or indirect costs by way of the burden centers. In varied production, further distinction must be made between a cost computation for brands and series and one for single and piece products. Contrary to the job method, a second division is necessary in serial production after the cost of the series or brands has been computed in order to determine the cost of each unit. For comparative purposes industries with the process cost system necessitate a uniform borderline between direct and indirect costs. Yet any development of cost finding in individual enterprises toward a stronger direct distribution of every cost item should be furthered.

d. In assembly-type industries, an exact cost determination for each performance is only possible under certain conditions; only the costs of the entire production can be determined with exactitude. It is quite essential in cost distribution to determine whether the distribution is executed according to specific orders or according to fiscal periods. Because several of the above-discussed methods are employed simultaneously in many industries due to the diversity of their products, it is necessary for the group or association to provide for directions uniformly applied in order to assure a comparable basis.

3. a. Cost distribution with the aid of keys or symbols is a characteristic feature of the allocation of indirect cost. Symbols are needed for the distribution of the costs among burden centers and for the allocation of costs from the burden centers to the individual units.

b. Symbols must be 1) proportional to all factors which influence the cost calculation, and 2) quickly ascertainable. These requirements are not satisfactorily fulfilled if only one key is used for the distribution of all costs among the burden centers or for the distribution of dissimilar items upon a unit. Correct cost accounting requires in this case the application of varied keys which again presupposes sufficiently numerous divisions of the various cost centers. Distribution by symbols should tie up closely with the performances of the various centers or departments.

c. The execution of cost comparisons requires homogeneity and continuity of the principles upon which these symbols were based.

E. Costs: classified, departmentalized, and distributed.

1. Classification of costs.
   a. Accounting for the various kinds of costs finds its constituent elements such as wages, salaries, material, and depreciation in the general books.
   b. The number of classes depends upon the type and size of the industry as well as upon the requirements of a satisfactory control and exact allocation of all costs. The individual firm should extend its system as far as seems economical within its structure.
   c. With regard to the types of costs as they are listed under class 4 of the chart of accounts,[4] the following points are to be considered:
      1) The division of the various classes of costs (particularly raw material, supplies, direct and indirect labor, as well as special costs) should be as uniform as possible depending upon the size of the company.
      2) Special costs mean those types which can be allocated directly to the unit produced. These special costs may again be divided into costs for manufacturing and for distribution. The most important kinds of special costs for manufacturing are: definite development or design costs, specific tools, such as models, special tools, licenses; for distribution: freight-out, cartage, commissions, turnover tax.
      3) The directions issued by the groups should clearly establish the rules with regard to price reductions such as rebates, discounts, bonuses and allowances. They are to be recorded separately from extraordinary expenses or costs, for they are not regarded as factory or business expenses but as reductions in the sales prices quoted.
      4) The method of recording income items from the sale of scrap must be uniformly regulated.
2. Departmental cost accounting.
   a. This method divides the entire plant into departments.
   b. Such a division fixes responsibilities and permits a continuous supervision of all costs in the plant. Manufacturing and distribution are to be separated. The allocation of the costs of management and administration should be discussed in the set of rules established by the individual group. The fact that administrative costs may fall partly upon manufacturing and partly upon distribution should not be overlooked.
   c. The departments can be established from various points of view, technical, local or otherwise. Exact allocation of costs requires particularly the formation of new cost centers if 1) certain sections of the plant are taxed unequally by the units produced, 2) by-products occur, 3) independent performances are in evidence.
   d. Besides the chief cost centers whose burden is directly allocated to the units, it is also

[4] See page 182 of the ACCOUNTING REVIEW, June, 1940.

advisable to create secondary centers which again distribute their costs among other centers.

e. The greatest possible part of the costs is to be individually allocated.

f. A uniform and extensive division of the departmental costs according to types is necessary in order to assure strict control.

g. Departmental cost accounting can be carried through on the general books or in close connection therewith with the aid of a cost sheet (expense distribution chart).

The cost sheet renders possible:

1) grouping the cost with respect to types and burden centers.

2) apportionment of costs among the various centers.

3) ascertainment of costs common to all centers.

4) calculation of standard figures.

h. Due to the fact that the construction of burden centers expresses the individuality of an industry or business, it is hoped that the standardization of the most important group of burden centers (purchasing, storing, manufacturing, distributing and administrative) may be accomplished. Yet the guiding principles issued by an industrial group or trade association should strive to standardize also the individual costs within a department, an aim which, of course, depends entirely upon the size and structure of the organization.

3. Allocation of costs or distribution of departmental costs.

a. Cost allocation distributes the cost among the individual units. Not only manufacturing for future sale, but also production for the company's own use (buildings or plants, power, repairs and maintenance jobs) are part of this distribution of costs.

b. The allocation of costs can be recorded in the general books or done statistically—in this case in keeping with the general books.

c. The units produced are to be defined according to the viewpoint expressed for cost supervision and exact cost allocation. In doing so, an extensive division of the units manufactured will be required when uneven stress is laid upon a factory section by the unit, or if the formation of intermediate cost centers occurs. Industries manufacturing a particularly large number of various items will find it economical to allocate costs only upon groups of performances. These groups containing manifold units produced do not present clear or particularly comparable results for a single item. In such cases it seems advisable to ascertain from time to time the cost of a single unit by an exact computation.

d. In order to fulfill its purpose, cost allocation must show a sufficiently large and uniform classification according to types and groups of costs.

e. The limitation of an intercompany standardization of the allocation of costs results from the differences of the performances in the branches of various industries. Yet, insofar as like

or comparable production and groups of production exist, the directions issued by each industrial group should aim for a uniform and extensive division of the costs per unit and for uniform allocation in order to assure comparability.

F. Degree of employment in relation to cost.

1. The division of the costs into "fixed" and "variable" (the former to a great extent independent of changes in labor employed) leads to a clear understanding of the relationship between cost and employment.
2. A preliminary step in the consideration of the employment changes for cost purposes is the use of standards computed on the basis of normal employment. Actual changes should be compared with regard to their position above or below the standard figures. Hence opinions can be formed as to the effect of the changes in employment upon the costs.
3. The directions issued by the group should possibly take into consideration the measurement of the degree of employment which is rather important in intercompany comparisons even if no improvement in its cost accounting methods has been made.
4. An understanding of the variable costs and their causes is furthered if, besides fluctuation of costs, variations in turnover are measured.

G. Uniform Cost Charts.

An essential aid for uniformity of cost accounting within the individual branches of the entire national industry is a chart of the cost structure. It is the purpose of the directions issued by groups to develop and to provide for the accomplishment of these principles of cost accounting laid down in these guiding principles.

IV. Utilization of Cost Accounting.

A. The goal of these principles is the execution of correct and uniform cost accounting in business and industry. The prerequisites for utilization of cost accounting are thereby created with the hope of greater economy and increased output. Cost comparison is a particularly informative type of utilization. If internal comparison is made, it is important to distinguish between comparisons of time periods, of actual and estimated output, and of different production methods employed.

B. The utilization of correct and uniform cost accounting of a single business becomes more valuable through intercompany cooperation in the form of external comparisons. Such a method is of importance because it indicates the position of the individual firm within the framework of the industry as a whole. These guiding principles will build, with due consideration for the individual firm's needs, a sufficient uniformity of cost accounting which forms the prerequisite for the comparison between the various companies.

Throughout the article it has been apparent that the rules with respect to a uniform accounting system and to cost accounting aim for the greatest possible comparability. The Board of Industrial Economy intends to issue soon its suggestions concerning internal and external analysis followed by a study of accounting terminology. A recent letter from the director of the Board to the author stated that this work has been interrupted for the present. As soon as material is available, this discussion will be continued.

STOCK AND OTHER DIVIDENDS AS INCOME

THOMAS YORK

THE QUESTION concerning the types of stock dividends which are income and the types which are not income has assumed importance chiefly in relation to Federal income taxation. Beginning with its decision in Koshland v. Helvering, (298 U.S. 441), the Supreme Court of the United States has laid down and applied a general rule for determining the taxibility as income of any given type of stock dividend. This rule, frequently referred to as the "different interest" rule or test, was expressed in the following language in the Koshland case:

> "On the other hand, where a stock dividend gives the stockholder an interest different from that which his former stock holdings represented he receives income. The latter type of dividend is taxable under the Sixteenth Amendment."

From its first enunciation it became quite evident that the rule was hardly calculated to remove the general uncertainty surrounding the question and to render it possible to make dependable prognostication as to whether types of stock dividends not as yet passed upon by the Supreme Court were in the taxable or the nontaxable class. On the contrary, far from a satisfactory answer to the general question being supplied by the Koshland case, it is still necessary to await the Supreme Court's construction of its own rule as applied to each type of stock dividend. By the general admission of authoritative commentators, the rule has not met the demands of the situation by furnishing a general workable test for determining the taxability of stock dividends.[1] Indeed, it appears as if the rule was destined to be gradually superseded by a series of specific and more or less unrelated rules each applying to a particular kind of stock dividend. In none of its decisions has the Supreme Court expounded its general rule or analyzed any underlying principle; on the contrary, it has contented itself with little more than a bare statement of the rule as given in the Koshland case.

It is not the primary purpose of this discussion to attempt an appraisal of the general soundness of the Supreme Court's position with reference to the taxability of stock dividends as income under the Sixteenth Amendment. Accordingly, only incidental consideration will be given to the court's "different interest" rule, or for the matter of that, to Federal taxation of stock dividends in general. The question of whether a specific type of stock dividend constitutes income to the recipient or not, is of interest apart from the taxation of income. It is a part of the general accounting problem of the proper determination of periodical income for general business purposes, and also bears on the law with respect to dividend declarations. It is, therefore, proposed to examine the question mainly from this general business point of view. This task will be made easier if consideration of stock dividend taxation is avoided for the most part, partly because of the arbitrary factors present in the determination of the taxability of stock dividends, and partly because of what appears to be the very hopelessness of trying to cope with the present rather confused

[1] See, for example, "The Present Status of Stock Dividends under the Sixteenth Amendment," by George F. James, *Chicago University Law Review*, February, 1939, p. 215, for a general description of the unsatisfactory status of the law.

situation with respect to the taxation law. But perhaps the most persuasive reason for giving only incidental attention to the taxation aspect of stock dividends is that a radically different approach is made to the fundamental problem from that indicated by the Supreme Court's "different interest" rule, and nothing could be gained, but on the other hand, much would be lost, by mingling consideration of the two points of view.

With respect to stock dividends as with respect to other corporate matters, the two fundamental classes of stock, namely, non-participating preferred stock and common stock, must be sharply distinguished from each other, as they in reality constitute separate types of securities. It is the common failure to differentiate sufficiently between stock with rights to prior, and therefore, limited distributions, and stock with rights to only subsequent but unlimited distributions, both when the corporation is a going concern and when it is in process of liquidation, which is responsible for much of the confusion not only in the present law pertaining to the taxation of stock dividends, but also in the general law concerning the rights of the preferred stockholders on the one hand and the rights of the common stockholders on the other. It will be necessary, therefore, at the very outset of this discussion to make a clear-cut differentiation between these two general classes of stock and to bring out into somewhat sharper relief some of the more significant points of contrast than is usually done.

The ordinary share of preferred stock, whatever its relative priority rights are where two or more preferred issues are outstanding, is essentially a money claim against the issuing corporation, for dividends while the corporation is a going concern and for principal or liquidation price upon its being wound up and dissolved. To be sure, the claim is of a contingent nature, but the important fact is that such as it is, it can only be discharged by the payment of a definite sum of money, barring the effectuation of a compromise arrangement with the individual preferred stockholders or a reclassification of the stock under statutory authority. In the case of cumulative preferred stock, the claim is a fixed liability so far as concerns the amounts payable, and a contingent liability so far as concerns the time of paying those amounts since payment of dividends is dependent, first, on the existence of an available surplus, and second, on the discretion of the board of directors, while the principal is payable only upon the happening of a more or less fortuitous event, the winding up and liquidation of the corporation. In the case of noncumulative stock, the claim is contingent both as to amount and time of payment so far as dividend payments are concerned. Preferred stock, thus, in a very essential respect resembles a corporate bond or other creditor claim against the corporation. It is a type of money loan, and the so-called dividends paid on it are in reality installments of money interest, although, of course, the legal remedies available to preferred stockholders to effect collection of these interest installments and of repayment of the principal, upon the winding up of the corporation, are radically different from those open to corporate creditors, because of the contingent nature of the claims in the one case and the fixed and absolute nature of the claims in the other case.

While all prior interests in the corporation, both creditor claims and preferred stock issues, represent, at least ordinarily, direct money claims against the corporation of one type or another, the final or residual interest, universally referred to as common stock, is something quite different. A share of common stock can in no sense be regarded as a money claim. It merely represents, as will presently be

made clear, an undivided fractional interest in, or a uniform proportional part of, the entire corporate property such as it happens to be, subject, however, to the prior money claims of creditors and preferred stockholders. Common stockholders are not entitled as a matter of absolute right, or at least not under all circumstances, to the payment in money either of dividends declared by the going concern or of their distributive share of the net or remaining assets upon liquidation. If the nonmonetary assets of the corporation include some of a divisible character, which will lend themselves to equal and prorata distribution among the common stockholders, they may, at the discretion of the directors or the liquidators, as the case may be, be divided among stockholders in kind, without first being converted into cash. Dividends, ordinary or liquidating, on common stock, are thus intrinsically divisions of corporate property rather than mere payments of money, and the term "dividend" may in consequence be said to apply to distributions to common stockholders with greater propriety than to the money payments made to preferred stockholders. Moreover, the amount of a common stock holding can be expressed only in terms of the number of uniform fractional parts or shares held, and not in terms of a sum of money, except where the sum represents the market value of the shares or "book value" (part of the corporate net worth). If one is the owner of 300 common shares out of an outstanding total of 500 shares, he in effect holds a three-fifths undivided interest in the net corporate property, after discharge of the money claims of creditors and preferred stockholders. The customary method of indicating the amount of common stock held by one, in terms of the aggregate par value assigned to the shares, is merely a method of stating the proportion which the shares constitute of the entire common stock interest. It can have no other significance so far as denoting the amount of common stock held is concerned.

The fact that nonparticipating preferred stock constitutes a security *sui generis*, more closely, however, resembling bonds than common stock, is largely overlooked or ignored. All too frequently a tendency is evinced to consider preferred and common stockholders as substantially constituting a single class, in general denominated "stockholders." One instance of this tendency, for example, is the adoption by the courts of the general rule that preferred and common stock are identical except in the respects specified in the charter, and the narrow and rigid construction with which that rule is sometimes applied. It is overlooked that the right to prior payments accorded to preferred stock and the limitation of the amount of such payments which such prior right necessarily implies, renders such stock a fundamentally different type of security from common stock, and instead of making full allowance for that fact and dealing with the two classes of shares accordingly, there is a well-nigh universal tendency to assimilate them, as if they at bottom constituted a single class of security, having certain basic rights in common. There can be little doubt that this misapprehension, shared alike by legal authorities as well as laymen, is largely responsible for the conflict and confusion which now obtains in corporate practice and in the law as regards the respective rights of the two classes of stockholders. A capital example of this confusion is supplied in jurisdictions where under the statute pertaining to alterations of the charter it is possible for common stockholders, by reason of their preponderance of voting power, to force a change in the preferred stock provisions of the charter over the unanimous dissent of the preferred stockholders.[2]

[2] Contrast this lack of protection of the rights of the preferred stockholders with the rigor with which the bond indenture in its ordinary form is enforced. No

If the real position of the preferred stock holders is fully appreciated, it will be realized that preferred stockholders are not members of the corporation in any legitimate sense, but merely third parties, dealing with the corporation on more or less the same footing as creditors, and that the affairs of the corporation cannot be managed in their interest any more than they can be managed in the interest of its creditors. It is the duty of the board of directors to conduct the business of the corporation so as to produce the largest possible earnings, and as the common stockholders are the owners of the end-equity or residual stock interest, it follows that the corporation is formed and its business is run primarily for their benefit, and the election of the directors and the control of the corporation must be in their hands, except when that control may be temporarily transferred to the preferred stockholders upon default in preferred stock dividend payments or in the observance by the corporation of other provisions of the preferred stock contract. The common stockholders and they alone are the real members of the corporate association, irrespective of the fact that the preferred stockholders may be given a permanent but necessarily a minority voice in the election of directors. The charter of the corporation, apart from its aspect as a state grant, evidences solely the agreement among the common stockholders. The preferred stock contract though included in the charter, is not in reality an integral part of that document but a separate agreement more or less comparable to the indenture under which bonds are issued.[3]

dissenting bondholder is compelled to submit to a change in the terms of the indenture except in a statutory reorganization proceeding.

[3] It is interesting to note in this connection the practice of some companies not to include in the charter, provisions relating to stock option warrants extended to preferred stockholders, but to incorporate them in a separate indenture executed with a trustee. A portion of the agreement between the corporation and the preferred stockholders is thus handled in the same manner as a bond indenture.

On the basis of the fundamental difference between preferred and common stock as outlined in the foregoing paragraphs, all stock dividends may be grouped into the following two general classes:

1. Dividends declared in any class of stock on preferred stock.
2. Dividends declared in any class of stock on common stock.

This two-divisional grouping furnishes the basis for a logical approach to the consideration of the question as to which stock dividends may fairly be regarded as income to the recipients and which may not be. It will be observed that the grouping is entirely predicated upon the difference in the classes of stocks on which stock dividends are declared. As will be learned in the course of this discussion, the type of stock in which the dividend is declared is not a factor in the determination of which stock dividends are, and which are not income.

It requires no extended argument to show that the first of the foregoing types of stock dividends, that declared in any kind of stock on preferred stock, is income to the preferred shareholders under all circumstances. It is only necessary to recall the basic nature of preferred stock, as already explained, to see that a dividend in any class of shares on preferred stock is as much income as a cash dividend on the same class of stock. It is simply not open to any doubt that preferred stockholders are enriched in consequence of such dividend by the amount of the market value of the dividend stock at the time of the distribution. Both the gross and the net assets (gross less creditor claims) of each preferred stockholder are increased by the stock dividend, and it is the increase of net assets resulting from one form of gainful activity or another, including loans and leases of money or property, which is referred to by the term "profit." There is no more warrant for questioning the fore-

going statements than there is for questioning that an interest instalment on bonds which is normally payable in cash, but which under a special arrangement made with the bondholders is discharged by the delivery of the obligor company's stock, is nevertheless income to the bondholders. A dividend on preferred stock, like interest on bonds or any other form of corporate obligation, is essentially compensation for the use of money loaned, and it is immaterial in what form it is paid so far as the question of its constituting income to the recipient is concerned. Like interest on bonds, dividends of whatever kind on preferred stock represent losses to the common stockholders, owners of the residual interest, but pure gains to the preferred stockholders. This is true even if there are no accumulated profits and the dividend must be charged to paid-in surplus. A dividend on the preferred stock in the declaring corporation's stock is in effect a cash distribution equal to the current market value of such stock, coupled with the simultaneous and compulsory reinvestment of the cash in the newly issued stock.

Instances in which dividends on preferred stock are regularly payable only in shares of stock, either of the same or some other class, are exceedingly rare, and this is not surprising, because such dividends are of a somewhat anomalous nature. The ordinary preferred stockholder is an investor, and like the bondholder, he prefers to receive a fixed periodic return on his investment, which in the final analysis must consist of cash. He is generally unwilling to enter into an arrangement whereby he would be obliged to reinvest his return in a specified type of stock of the same company, as he does to all intents and purposes when the dividend is payable in stock. To be sure, where there is an active market for the dividend stock, he could on the occasion of each dividend immediately convert his new investment into cash; but this at best would be true only of the comparatively few dividend stocks which happened to be actively traded in open markets. In the great majority of cases it would be found very difficult, and in many instances practically impossible to dispose of the dividend stock within a reasonable period of time without serious sacrifice of value. Moreover, since the preferred stockholder is entitled only to a limited amount of dividends in any year, he wants that to be a fixed sum. To offer him stock, dividends on which are payable in a fixed amount of some type of shares, is to deal with him as if he were a speculator, since the return on his investment as measured in the money of the realm would vary from one dividend date to the next, as the market price of the dividend stock fluctuated.[4]

The more normal instances in which share dividends are distributed to prefered stockholders in lieu of cash dividends are the special occasions, first, when as the result of a compromise agreement with preferred stockholders cash dividends in arrears on preferred stock are paid off in the company's shares, and second, when the preemptive right of stockholders to subscribe for a new issue of stock is extended to preferred stockholders as well as to common stockholders.[5] In the latter case, if the new shares are offered for less than

[4] It would, of course, be possible to provide in the preferred stock contract for an adjustment of the stock dividend rate to offset changes in the market value of the dividend stock, so that a stock dividend variable as to the number of shares but of a relatively fixed value would be received. But such an arrangement would be cumbersome, and would not, moreover, overcome the preferred stockholder's objection to the compulsory reinvestment of his return in the stock of the same company. The objection would naturally be especially strong where the dividend consisted of common shares.

[5] That the issue of stock rights results in the distribution of a stock dividend becomes quite evident when a subscription for stock at less than market value is viewed as consisting of a subscription for a portion of the offered stock at full market value and the receipt of the balance gratis or as a stock dividend. The total market value of the shares constituting the stock dividend equals or tends to equal the total market value of the subscription rights.

their market value, the preferred stockholders receive an extra dividend equivalent to the market value of the subscription rights. While such privilege of subscription is at times granted to preferred stockholders, there can be little doubt that the grant is made under a misapprehension as to the nature of the preemptive right of stockholders, as it is quite clear that the preferred stockholders are not entitled under their contract with the corporation to the extra dividend which the stock rights represent, unless, of course, the contract contains an express provision to that effect.

In numerous instances preferred stockholders are entitled to a so-called optional dividend. They have the right to demand, in lieu of a stipulated amount of cash dividends, a certain number of shares of a specified class. It is evident, however, that when a preferred stockholder exercises his option and takes stock in place of cash, the transaction cannot be regarded in its entirety as a stock dividend. From the moment the directors declare such optional dividend, the corporation incurs a cash liability, and if a preferred stockholder subsequently elects to take stock in lieu of cash because its current market value is greater than the cash dividend credit, he in effect applies the credit against the subscription price for the stock. An optional dividend of this nature thus consists of a cash dividend coupled with a subscription privilege, which is similar to ordinary stock rights save for its lack of transferability and its not being evidenced by certificates or warrants. Such dividend is, accordingly, not a stock dividend, since as already pointed out, a stock dividend is in effect an involuntary cash subscription to stock. But in any event when the preferred stock holder, in an optional dividend, takes stock instead of cash, it is clearly income to him.

The discussion of the first of the two general types into which all stock dividends fall, namely, that declared on preferred stock, may be concluded with a few general observations aimed to define more comprehensively the scope of the application of the conclusions arrived at in the foregoing discussion with respect to such stock dividends. It may be said, in the first place, that it does not matter of what rank preferred stock may be, whether senior or junior to another preferred issue; a stock dividend declared on it is income. Likewise a dividend declared on participating preferred stock in shares of stock in lieu of the preferred cash dividend, is income. Participating preferred stock is in the nature of a compound stock, uniting preferred with common stock, and if a stock dividend is declared on the preferred portion of the stock, it is income. These latter remarks also apply to the so-called common stock when the issue combines the characteristics of a second preferred stock and common stock, as in the instance where stock commonly referred to as participating preferred stock is entitled to first preference, the so-called common stock to second preference, and then both have the right to share alike, or in some fixed proportions, in all subsequent distributions in any period. Where stock is preferred only as to dividends but not as to principal or liquidation payment, or, vice versa, where its right to prior payment applies only to the liquidation payment, there appears to be no method of absolutely determining whether a stock dividend upon it is or is not income, since in that case the stock is partly preferred and partly common, and dividends received on common stock are not strictly income, as will presently be made clear. It would seem however, not unreasonable to consider as income a stock dividend declared on stock with prior rights to dividends. Where there are two so-called common stock issues, both of which are entitled in any year to share in dividends equally or in certain proportions, up to a stipulated amount, either on a share for share basis or in ag-

gregate amounts, but one of which is entitled to additional dividends for an indefinite amount in the same year, the unlimited of the two issues is actually a participating preferred stock, while the other or limited issue is non-participating preferred stock. The limited or preferred dividends which they are both entitled to receive simultaneously, will ordinarily be payable in cash; but if stock instead of cash is distributed on them, it is necessarily income.

Attention will now be turned to the other of the two general groups into which all types of stock dividends have been divided for the purpose of the present discussion, namely, that consisting of any class of shares declared upon end-equity or common stock, properly so-called. Whether such stock dividends can be considered income to the recipients can be most satisfactorily answered by first giving attention to the more inclusive question of whether a dividend consisting of the distribution of assets, cash or property, to the common stockholders, can strictly and upon any reasonable principle, be regarded as constituting income to them. Obtaining a correct answer to this latter question necessitates consideration at the outset of the nature and constitution of a corporation organized for pecuniary profit, and particularly the relationship which the common stockholders sustain to the corporation and the corporate property.

It may in general be said that legal authorities are divided into two principal schools of thought on the issue as to what the basic constitution of a corporation is. According to the view of the one school, or the so-called "fictionists," a corporation is primarily created by the state, and exists separately and apart from the stockholders. In the view of the other school, the "realists" as they are referred to, a corporation is an association of the stockholders, and is created by their agreement of association, the state only granting them permission to conduct the business under the corporate form, with its special rights and privileges. Both schools do not appear to distinguish between common and preferred stock in this connection, but regard the holders of both types of stocks as members of the corporation. However, in any consideration of what a corporation fundamentally consists of, the distinction must be carefully observed, because only the common stockholders, the owners of the residual interest, are members of the corporation, and only they are really concerned in any discussion of the nature of a corporation.

There can be little question concerning which of these two views of the nature of a business corporation enjoys the more widespread acceptance. The theory that the corporation is a creature of the state and possesses a separate existence, independent of the stockholders, has been adopted unqualifiedly by the great majority of legal authorities, and is almost universally accepted with absolute implicitness in lay circles. It is undoubtedly true that corporation law in many of its branches is impregnated with this "separate entity" doctrine, as it is called, and has been greatly influenced by it. The other school, the "realists," who are comparatively small in number but of high respectability, reject root and branch the "separate entity" theory of the corporation. According to their view, it simply does not make sense to consider that a being supposed to be created by the fiat of the state can have actual existence independently of the stockholders, or that property can be owned by any others than natural persons, individually or as collective bodies. A clear and concise expression of this "realistic" view of the corporation is the following from Morawetz on Private Corporations (2nd ed., sec. 227): "The statement that a corporation is an artificial person or en-

tity, apart from its members, is merely a description in figurative language of a corporation viewed as a collective body; a corporation is really an association of persons, and no judicial dictum or legislative enactment can alter this fact."

While there is, of course, a difference between these two theories of the essential nature of a corporation, it is doubtful if the difference is as great as is sometimes supposed. Under both theories the entire corporate system consists of three more or less distinct entities or bodies, namely, the common stockholders as individuals, the corporation proper, and the board of directors. The interrelationship of these three bodies is more or less the same according to either view of a corporation's fundamental character, and as described by the parts they play in the corporate functioning, it is as follows: The stockholders entrust a certain amount of capital to the corporation for the prosecution on their behalf of the kind of business authorized by the charter; the corporation holds title to that property (as well as property obtained from creditors, preferred stockholders, and operations), and can make whatever disposition of it it deems necessary and desirable for the legitimate conduct of that business; in the management of the business it can and does act only through representatives or agents, the board of directors, who, however, are elected by the individual stockholders. Expressed in more technical, legal phraseology, the relation between the stockholders and the corporation is virtually that of a trust, with the stockholders being at once the creators and the beneficiaries of this virtual trust and the corporation the trustee, while the relation between the corporation and the board of directors, according to a well-settled rule of the law, is that of principal and agent.[6] Under the "realistic" theory, although the corporation is taken to be an association of stockholders, it is nevertheless regarded as something quite distinct from the individual stockholders, and therefore, as also constituting a separate entity, although of a different nature from that under the other or "fiction" theory. Thus, both theories of the corporation are in reality "separate entity" theories, although the characterization is usually applied only to the "fiction" theory.

The intervention, according to both theories of the corporation, of a separate and more or less intangible entity, the corporation, between the stockholders and the board of directors, the actual parties in the general organization, adds a complicating element to the entire conception of the corporate structure, and appears to have resulted in a tendency to identify the one theory rather closely with the other. This tendency is evinced, for example, in the statement, not infrequently made by courts endorsing the "realistic" theory, to the effect that while a corporation as an artificial being has no reality, nevertheless the use of the fiction is justified on the ground of its being a convenient device or convention for summarizing the rules of law pertaining to the rights of the actual parties, the stockholders in their collective capacity.[7] One is, indeed, tempted to ask whether it would not be possible, without doing violence to all proper and necessary rules of law for the regulation of corporate relationships, to adopt a simpler conception of the corporate system and eliminate much of the confusion now prevailing in the law concerning the subject, by discarding the idea of an intermediate entity and bringing the stockholders into direct relationship with the board of directors.

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[6] Note the patent inconsistency in this general view of the corporate structure—the agent, the board of directors, being appointed not by the principal, the corporation, but by third persons, the stockholders.

[7] See, for example, Southern Securities Co. v. State, 91 Miss. 195, 445 So. 985.

The latter body would then be regarded in legal theory as holding the legal title to the corporate property, as it appears to hold this title in actual fact, if the holding of legal title to property means the exercise of dominion over it.[8]

It is undeniable that whether the corporation is viewed as a creature of the state, or as an association formed by the agreement of its members, or as being the board of directors, it is an entity separate and distinct from the common stockholders. This is inherent in any system whereby a group of individuals contribute capital to a business and appoint a smaller group of representatives to prosecute the business in their behalf. But while much importance is usually attached to the fact of the corporation being a separate or "legal" entity, such separateness has of itself no significance. What is significant is the relation between the stockholders and the corporation with reference to the property held by the latter. Is it a creditor-and-debtor relationship; or that of bailor and bailee; or is it essentially a trust relationship?

An examination of the cases shows a distinct proneness on the part of the courts, in the face of the facts already pointed out, to view common stockholders as standing in a creditor relationship to the corporation, with their claims, to be sure, subordinated to the ordinary corporate liabilities.[9] On that basis some semblance of an argument can be adduced for the general proposition that dividends of any kind distributed to common stockholders constitute income to them. Reasoning from such premise, it can logically be argued, for example, that cash or other property distributed to common stockholders is a loss only to the corporation and an unqualified gain to the common stockholders, being a return on their investment essentially like any interest received on an ordinary money loan. In this view of the corporate relationship, the common stockholders are more or less third parties or strangers to the corporation and in the same category with ordinary creditors and preferred stockholders. On this basis it can be said with a certain amount of plausibility that even a dividend in common stock distributed to common stockholders is income, contrary to the United States Supreme Court's holding in Eisner v. Macomber (252 U.S. 189).

But the fallacy in this entire course of reasoning becomes apparent at once upon giving a moment's thought to the obvious fact that by reason of their interest being the residual one, the gain which common stockholders acquire individually when they receive a dividend is completely cancelled by the loss they sustain in consequence of the reduced value of their re-

[8] It is interesting to note in this connection that the old designation for directors was "trustees." Also, in Burrill v. Nahant Bank (2 Metc. 163), an early Massachusetts case, the court said: "By the by-laws of these corporations [banks], and by a usage, so general and uniform as to be regarded as part of the law of the land, they [directors] have the general superintendence and active management of all the concerns of the bank, and *constitute, to all purposes of dealing with others, the corporation.*"

[9] This so-called liability to stockholders is referred to as a "capital liability." The following excerpt from a case decision (Hamlin v. Toledo, St. Louis and Kansas City R. Co., 78 Fed. 664) is a typical description of this view of common stockholders' relations to the corporation: "There is a sense in which every shareholder is a creditor of the corporation to the extent of his contribution to the capital stock. In that sense every corporation includes its capital stock among its liabilities. But the creditor relation is one which exists between the corporation and its shareholders. It is a liability which is postponed to every other liability, and no part of the capital can be lawfully returned to the stockholders until all debts are paid for or provided for." As a matter of fact, the term "capital liability" is employed very illogically even according to the sense in which it is purported to be used. As exemplified by the foregoing decisional quotation it merely refers to the corporation's stated capital, or the amount which when added to the amount of the liabilities to ordinary creditors fixes the aggregate sum below which the corporate assets may not be reduced by distributions to stockholders. If the interest of the stockholders is to be viewed as a liability, then it should embrace the entire net assets (exclusive of the liquidation price of any preferred stock), or at least the paid-in portion of them, and not merely the amount set up as stated capital, which according to the present-day practice of some corporations, for example, is arbitrarily fixed at a nominal sum.

spective interests in the corporation. As already pointed out, there is in this respect a wide difference between the position of the common stockholders, on the one hand, and the position of those who own any form of prior interest in the corporation, bondholders and other creditors, and also preferred stockholders. The interest and dividends received by the latter groups is an unqualified gain to them, since it is not offset by any loss in the value of their interest or prior equities by reason of the receipt of such payments. But the very opposite is true of dividends of any kind distributed to common stockholders.[10] The fundamental error committed by the court is in viewing the common stockholders as being in a creditor position with respect to the corporation and overlooking facts which make it plain that no such relationship exists, and in the very nature of things cannot exist. The truth, made obvious upon an examination of the factual situation, is that, as already pointed out, the relationship is one of a species of trust, in which the corporation is the trustee and the common stockholders are the beneficiaries.

It hardly requires any further elaboration of the character and constitution of the corporate organization to make it evident that whichever of the two prevailing conceptions of that organization is adopted, the "fiction" or the "realistic," the common stockholders are in a very actual sense the beneficial and therefore the real owners of the corporate property. To borrow words used by Morawetz in another connection, no judicial dictum or legislative enactment can alter that fact. The common stockholders have established, for their own benefit, what is in the nature of a business trust, each contributing a portion to the common fund; and they have appointed a board of directors to employ that fund in the type of gainful pursuit authorized by their mutual agreement, the charter, for the purpose of augmenting it, or earning a profit if possible, and for the purpose of having that surplus property ultimately distributed to themselves.[11]

[10] This argument was apparently presented in the hearing before the United States Supreme Court in Lynch v. Hornby (247 U. S. 339), an income tax case involving the taxation of a cash dividend on common stock. It was dismissed by the court in the following words: "We do not overlook the fact that every dividend distribution diminishes by so much the assets of the corporation, and in a theoretical sense reduces the intrinsic value of the stock. But, at the same time, it demonstrates the capacity of the corporation to pay dividends, holds out a promise of further dividends in the future and quite probably increases the market value of the shares." This dictum is subject to the following criticism:

First, the loss in the market value of common stock by reason of a cash dividend disbursement is actual and not merely theoretical, as anyone acquainted with dealings on stock exchanges knows. When a stock upon which a dividend is declared begins to sell ex-dividend, its market value is marked down by the amount of the dividend. Whether the stock will recover that loss or not will depend upon future events in relation to the corporation.

Second, a corporation's capacity to pay dividends can hardly be measured by the mere fact of the payment of a dividend. It is measured by the accumulated earnings as reflected in the surplus account and the general earning power, and in the case of cash dividends, also by the corporation's cash position.

Third, the payment of a dividend is not necessarily an indication of the corporation's earning power, and far from causing the market value of the shares to increase, it may have the contrary effect, if its declaration was injudicious, the company, for example, becoming short of cash in consequence of it.

[11] Of course, the corporation is not a business trust founded on the principles of the common-law trust, but one *sui generis*, which requires special legislative sanction for its establishment. The rules of law pertaining to common law trusts show fundamental divergences from those pertaining to corporations. One of the most important, if not the most important, of these differences is that in the common-law trust, not modified by statute, or by the terms of the trust itself, or by contract, the trustee is personally responsible for all liabilities incurred for account of the trust, although he is allowed to indemnify himself from the trust fund for any payments he legitimately makes for account of the trust. (See Restatement of the Law of Trusts, sec. 261.) If the trust fund is insufficient to discharge the trust debts, he must personally stand the loss. On the other hand, in a corporation neither the stockholders nor the directors are responsible for corporate liabilities, but only the corporate fund or assets. A corporate liability is a claim, not against any natural person or body of natural persons, but against the specific items of property which constitute the corporate assets, and in that respect it resembles a mortgage, which taken by itself and apart from the mortgagor's personal promise, the bond is merely a claim against the mortgaged property. One is tempted to speculate whether the theory of a corporation being a "legal entity," separate from both

While the view usually held under both the "fiction" and the "realistic" theory of the corporation is that the legal as distinguished from the beneficial title to the property constituting the fund is in the separate entity commonly referred to as the corporation, it is not certain from the factual situation that this is true in any but a qualified sense. For it is to be remembered that in the final analysis the common stockholders have complete control of the property. For one thing, they are free at any time, by a vote of a certain majority or by a unanimous vote, according to the requirements of the particular jurisdiction, to revoke the trust, as it were, and divide the entire property among themselves, after discharging the money claims of creditors and preferred stockholders. But even while the corporate business is a going concern, the ultimate management or control of the corporate property is vested in the stockholders, who can determine policies by effecting changes in the charter or by-laws, or by substituting at any annual election a new board of directors. The legal title as held by the corporation is thus clearly conditioned upon the will and pleasure of the beneficiaries, the stockholders. Until the final division of the entire property, upon the winding up of the corporation, each common stockholder is, therefore, for all practical purposes the owner of a certain fraction of the undivided or common property, denoted by the number of uniform parts or shares he holds. His "interest," to use a commonly employed but rather vague term, is, therefore, essentially not unlike that of a member of a partnership, although the firm property is owned in common by the several partners in an aboslute sense, that is to say, legally as well as beneficially.[12]

Since the common stockholders substantially own the corporate property in common, it follows that whenever accretions result to that property from its operation as a business by the board of directors, the amount of each stockholder's undivided fractional interest in the common property is increased thereby. Hence it is evident that corporate profits are the profits of the individual common stockholders as and when they are realized by the corporation and before their division or distribution to the stockholders, in substantially the same sense as partnership profits are the profits of the individual partners as soon as they are realized. The later division among the common stockholders, by order of the board of directors, of property wholly or partially to the extent of the previously earned profits, either in the form of cash or some other divisible type of assets, adds nothing to the common stockholders' wealth and cannot be strictly and logically regarded as a gain or income then accruing to them. The division, or dividend as it is ordinarily called, is merely a physical act of distributing a portion of the common property among its joint owners, which, to be sure, can only be

stockholders and the board of directors, has not had its origin in the personification by the courts and legislatures of this limited corporate fund.

The conception of the corporate property being in the nature of a trust fund of which the stockholders are the beneficiaries, should be carefully distinguished from what is frequently referred to as the "trust-fund" theory, according to which the stated capital or the entire corporate assets, depending upon the version of the theory adopted, are viewed as a trust fund for the special protection of the corporate creditors.

[12] This conception of joint ownership of property by the common stockholders is really connoted by the term "common stock" in its original sense, as the term was at first used to designate the common or joint fund contributed by the incorporators, the word "stock" referring to the fund or property. A synonymous expression was "joint stock." If the corporate property is added to by the contraction of loans or issue of preferred stock, the common stockholders still remain in effect the joint owners of it in its entirety, but their joint ownership is then subject to the prior money claims of the creditors and the preferred stockholders. In MacLaran v. Crescent Planing Mill Co. (117 Mo. App. 40, 93 S.W. 819) the act of declaring a dividend is described as changing the right of each stockholder "from that of partner and part owner of the corporate property to a status absolutely adverse to every other stockholder and to the corporation itself, insofar as his pro-rata proportion of the dividend is concerned."

authorized by the board of directors so long as the corporation is a going concern and the directors continue as managers of the common property. The distribution does not result in a gain to the common stockholders any more than the partitioning of a parcel of real estate among the several individuals who own it in common, yields a gain to them.[13] Nor can it even be contended, if the dividend consists of assets other than cash, that the common stockholders realize by such dividend a gain equal to any appreciation of the distributed property since its acquisition by the corporation, because the transaction is in no real sense an exchange negotiated between independent parties, but merely what is substantially a severance or partitioning of property held in common.[14]

If, as is maintained in the preceding paragraphs, no dividend consisting of a distribution of assets to common stockholders is income to them, it inevitably follows that neither a dividend in bonds, nor one in any other form of corporate obligations, nor a dividend in any class of stock, can be income to the receiving common stockholders. A dividend in any form of corporate obligations, including bonds, merely represents in effect an undertaking to make a future division of assets among their co-owners. A dividend on common stock in the same class of shares, of course, merely results in a subdivision of the outstanding common shares without affecting any substantial interest of the common stockholders in the corporate property—an increase in the number of uniform parts into which the common ownership of the corporate property is divided but a corresponding reduction of the size of the parts.[15]

Where a dividend on common stock is declared in some class of preferred stock, it resembles in one respect a bond dividend, in that it represents a claim for a definite principal sum of money and for contingent interest payments thereon. In another but less significant respect it approximates the nature of a dividend in common stock, because the principal of the preferred stock is not payable until the winding up of the corporation and dividends on it are payable only out of surplus and only at such times as the directors may in their discretion decide. However, whichever view is taken of such stock dividend,

[13] In Lynch v. Hornby the United States Supreme Court pronounced a cash dividend as income to common stockholders under the Sixteenth Amendment. The court said: "The stockholder is, in the ordinary case, a different entity from the corporation, and Congress was at liberty to treat dividends as coming to him *ab extra* and as constituting a part of his income when they came to him." The court was obviously influenced by the commonly held theory, but clearly erroneous in view of the factual situation, that common stockholders sustain a creditor relationship to the corporation.

It should also be pointed out that proportionate parts of accruing corporate earnings are to be viewed not only as profits earned on common shares but also as additions to the investment represented by the shares. Profit or loss on the sale of common shares by their holders is, therefore, the difference, one way or the other as the case may be, between the sales price received and the amount originally invested in the shares plus a proportionate part of the earnings accumulated since the acquisition of the shares and remaining undistributed, or less a proportionate part of the reduction of the original investment represented by the entire common stock issue, caused by operating or other losses or by distributions to common stockholders. In this respect also shares representing the residual interest in the corporate property differentiate themselves very radically from securities denoting prior interests, since the computation of the profit or loss on the sale of the latter must be based on original cost or investment, adjusted for any difference between the amount of that cost or investment and the amount by the payment of which those securities are discharged at maturity or otherwise.

[14] This conclusion is, of course, contrary to the Treasury regulations and court decisions with respect to the taxation of property dividends as income.

[15] Such dividend also usually results in the capitalization of surplus, or the reduction of the amount of the common property which may be divided among the common stockholders by order of the directors when the corporation is a going concern and contracting debts. But such capitalization is not a necessary sequel of a stock dividend of this type, and is due to the more or less arbitrary assignment of a so-called par or stated value to the common shares. The assignment of such "value," for one thing, operates merely as a rather cumbersome method of fixing a part or the entire amount of stated capital, which amount added to the amount of the total liabilities owed to creditors represents the aggregate sum below which the corporate property cannot be reduced by dividends on any class of stock. It is obvious that the amount of stated capital can properly and logically be fixed without reference to outstanding shares of stock.

it cannot be income to the common stockholders any more than a bond dividend or a dividend in common stock can be. The fact is that a dividend in preferred stock on common stock constitutes a recapitalization or reclassification of a portion of the common stock. By virtue of the dividend the common stock interest is divided into two parts, one of which is reclassified or converted into preferred stock, and the common stock interest accordingly suffers a loss in value exactly equal to the value of the newly issued preferred shares. Assuming for the sake of simplicity that at the, outset only common stock is outstanding it is not very material whether preferred stock is issued as a "dividend" to the common stockholders, who then retain the common stock certificates and acquire new certificates only for the preferred stock, or whether the common stock is "reclassified" by issuing in place of the old common certificates new certificates for both common and preferred stock, even if in the re-classification process the number of common stock shares is changed. Nevertheless, despite the essentially identical nature of these two kinds of transactions, they are subjected to different treatment under the Federal income tax law. As a stock dividend, the transaction is taxable under the holding of the United States Supreme Court in Helvering v. Gowran, (302 U. S. 238), whereas a stock reclassification or recapitalization was originally held to constitute an exchange of property subject to taxation in respect of any gain realized on the alleged exchange, but subsequently such gain was exempted from taxation by statutory provision.

The remarks made above concerning dividends on common stock, including those declared in shares of any class, apply to all types of end-equity or residual-interest stocks. They are true not only with respect to ordinary common stock but also with respect to the common-stock portion of so-called participating preferred stock, and with respect to common stock issued in several classes, distinguished from each other as to the proportion in which each class may participate in a declared dividend, whether such proportionate participation be on a share-for-share basis or on a class basis. The same remarks also apply to rights issued to holders of any type of end-equity stock, to subscribe for stocks or bonds, or to purchase property from the corporation, at less than market value.

On the basis of the foregoing discussion, the following two generalizations may be made, by way of summarizing the entire situation with respect to the nature of dividends in general, and stock dividends in particular, from the point of view of whether they are income or not:

First, all kinds of dividends, including all types of stock dividends, are income when declared on preferred stock.

Second, all kinds of dividends, including all types of stock dividends, are not income when declared on common stock.

These generalizations are true irrespective of whether the dividend in question is charged to an existing earned surplus, or to paid-in surplus in the absence of an earned surplus (due either to lack of accumulated earnings or to the previous capitalization of an existing earned surplus), or whether it is charged to and impairs the stated capital, even if the latter partially represents accumulated earnings in consequence of the previous capitalization of earned surplus. The same generalizations apply to all privileges issued to stockholders to subscribe for stock, or to purchase property or corporate obligations, below market value. Any such "rights" issued to preferred stockholders are income to these stockholders; and those issued to common stockholders are not income to them.

This discussion of stock dividends in respect to their being or not being income, would hardly be complete if notice were

not taken of the well-nigh universal practice of common stockholders to consider themselves as securing a return on their investment only upon receipt of a cash, property, or bond dividend, provided the dividend does not exceed the accumulated profits. Inasmuch as dividends are paid in cash in the great majority of cases, it may be said that this practice is due to a desire to account for any return on the investment on a cash-receipts basis. This departure from the strictly correct method, previously explained, of accounting for the return, has no doubt been motivated principally by considerations of convenience, amounting to practical necessity in the case of the common stockholders of large corporations.[16] However, there is hardly warrant, merely for the sake of consistency with an arbitrary practice based purely on considerations of expediency, for going to the length of treating also a dividend in common stock on common stock as income. As for dividends declared on common stock in preferred stock, it would appear that consistency of practice would require dealing with them in the same manner as with bond dividends, and therefore, treating them also as income, in view of the fact that preferred stock so closely resembles bonds.

But whatever method, logical or arbitrary, which common stockholders may adopt for their own private purposes in accounting for the return on their investment, the logical and equitable basis for taxing that return is corporate earnings, and the source from which the tax should be collected, are the common stockholders. Collection under the system now in force, of a tax, based on corporate earnings, from the corporation, and another, based on distributions, from the common stockholders, results in double taxation so far as the lower tax rates are concerned, and thus subjects common stockholders to unequal treatment as compared with partnership members and individual proprietors; and so far as the surtax rates are concerned, produces a situation in which the common stockholders are undertaxed where the annual distributions are less than the annual corporate earnings. A tax, based on corporate earnings and collected solely from the common stockholders, would cause some special problems of administration and collection, but this is the price that must be paid for the avoidance of an unequal levy of the tax.

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[16] An example of common stockholders treating corporate earnings as their own and setting them up on their books prior to any dividend distributions, is the practice in this respect of some parent corporations in relation to the income of their subsidiaries. Some accounting authorities disapprove of this practice on the ground, considered fallacious here, that the parent corporation is a separate entity, and therefore has no interest in the earnings of the subsidiaries until those earnings are distributed. The present writer is not aware of any case decision which deals with the question whether a dividend by a parent company based on the income of its subsidiaries, which is merely credited on its books and remains undistributed to it, is permissible under the existing law.

ACCOUNTING FOR APPRAISALS

HAROLD G. AVERY

If accounting records have been properly established and maintained on the basis of original cost, appraisal values should not as a general rule be used for operating purposes. Any basis other than original cost reflects a condition of values at a particular time, and subsequent price fluctuations might so alter the revaluation amounts that they would no more depict the present values *at some future time* than would the original cost figures. This does not preclude organizations from increasing their insurance coverage to compensate for the difference in price levels, nor does it hinder a company from providing additional reserves out of its earnings to compensate for the higher prices necessary to replace the fixed assets when they approach the end of their useful service lives.

Nevertheless, during periods of economic stress, many organizations are forced by conditions beyond their control to alter this principle in order to decrease their operating costs. Write-downs are necessary to account for price changes, extraordinary obsolescence (partial utility), and non-utility or abandonment of the property. Appraisals are made and adjustments accounting for the replacement values are recorded on the books with the thought that the price level, at the time the books are adjusted, will remain about the same for a long period of time. Fixed assets are written down because of obsolescence and abandonment in order to portray their present and prospective future worth under normal conditions. Such a procedure brings up two major questions: Shall the write-downs of property be charged against capital, capital surplus, earned surplus, or reappraisal surplus? What shall be done with the write-ups occurring when revaluation figures are greater than present book values?

Write-downs of fixed property should be first charged against any reappraisal surplus available. Such reappraisal surplus arises if the write-ups of the property during periods of increasing price levels have been properly credited. The shrinkages in property values are charged to this account if the price level declines and the appraisal policy results in a write-down of the property. Usually there is no reappraisal surplus available or there is an insufficient amount to take care of the drastic reductions in property values during a depression period. The question then confronts the management whether to charge capital, capital surplus, or earned surplus.

Theoretically, earned surplus should bear the burden of the write-down. The margin of safety for the creditors remains unimpaired, i.e., capital (legal capital) and capital surplus (capital contributed above the legal requirement) remain the same. When earned surplus is reduced, the stockholders' interests are naturally affected because it diminishes the amount of surplus available for dividends. If capital surplus instead of earned surplus is charged with the write-downs, the invested capital is impaired and the creditors' margin of safety is reduced unless an equal amount has been reserved out of earned surplus as not available for dividends.

Management may take the stand that it is under no obligation to provide for losses resulting from changing price levels, and accordingly does not charge these losses against earned surplus. A situation sometimes develops when earned surplus is insufficient to absorb the write-downs of fixed property even if the management concurs in such a policy. Perhaps no capital surplus is available. The board of directors then resorts to the reduction of

capital by legal action, and obtains the approval of the stockholders before making changes in the capital structure of the corporation.

In 1933, 71 companies wrote down their fixed assets by a charge to capital surplus created indirectly by reducing the stated or par value of the capital stock by legal action, i.e., by writing down legal capital, notwithstanding the fact that 46 of these companies had an earned surplus.[1] This indicates that the management of these companies did not accept the theory that earned surplus must be exhausted before any charge is made against capital surplus or capital. Twenty-five of the companies had no earned surplus; they had to resort to a write-down of their capital in order to absorb the losses. Mr. Arthur H. Carter, who made the study, stated briefly in the summary of his article: "No doubt there were some cases where the write-down was charged against earned surplus rather than capital surplus, but I think it is safe to say that such cases are much in the minority."[2]

When assets are written down because of price changes, the stockholders' equities in the corporation have been nominally decreased by that amount regardless of the net worth account used to absorb the loss. The actual net worth after devaluation may have the same purchasing power as the nominal net worth before the appraisal. The stockholders' point of view, however, may support the policy of charging plant write-downs against capital surplus because the earned surplus available for dividend distributions is left intact. The creditors, on the other hand, suffer a nominal decrease in their margin of safety as represented by the invested capital, although actually the purchasing power of their equity may remain the same. If all claims are properly met when they become due, the management does not necessarily hold that it is under any legal or moral obligation to make good such nominal impairment out of present or future earned surplus before dividend payments can be resumed. The question is still debatable. Nevertheless, from a theoretical point of view, write-downs of fixed assets should be absorbed by reappraisal surplus first, then earned surplus, capital surplus, and finally, if these are not sufficient, by legal action, wherein legal capital is reduced.

Extraordinary obsolescence arises in addition to regular depreciation charges when property values decrease faster than management has first anticipated, because of unforeseen economic changes. Sometimes this class of equipment is revalued and used as part of the reserve equipment, which is needed by the plant to meet certain peak requirements. Also, obsolete boilers, furnaces, and motors are maintained in order to assure the management of successful continuity of plant output in case of break-downs of regular plant machinery. Repairs and replacements can, therefore, be made to regular plant equipment without halting production.

Write-downs also result from complete abandonment of fixed property and its relegation to the scrap heap regardless of operating conditions. This class of property has suffered complete depreciation or obsolescence, and will never be used again because it exceeds the maximum needs of the business. If it still has material existence, it can be carried at its net salvage value figure; if its actual existence cannot be determined by a physical appraisal, the asset is stricken from the book records. Abandoned equipment should not be confused with partial-utility equipment which is still in use (normal or maximum conditions) as part of the reserve plant although it has suffered a decided decrease in value because of extraordinary obsolescence.

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[1] Arthur H. Carter, *NACA Year Book* (1933), p. 10.
[2] *Loc. cit.*

How are write-downs resulting from extraordinary obsolescence and abandonments handled in the capital accounts? In so far as the write-downs are not properly chargeable directly against current income, the general rule in effecting the write-off of fixed property (where the write-off is not a result of changes in the price level) is that it should be made against earned surplus, "so long as there is any earned surplus available."[3] According to Dr. Marple, when write-downs exceed earned surplus it is then proper to charge the excess against capital surplus, provided "Full disclosure is made, and any [earned] surplus arising subsequently is shown as dating from the date of absorption of the deficit."[4]

Competent appraisers sometimes show that replacement values are in excess of original cost or book cost figures. Then the question arises as to what shall be done with these appreciated figures. In a majority of cases, an appraisal report under normal circumstances is merely used for memorandum purposes, and no bookkeeping problem is encountered. The plant ledger appraisal may be incorporated in the bookkeeping records by attaching to each individual plant item a record of original cost (actual or estimated) and any other appraised value, such as replacement-new value or net-sound value. When cost values and replacement values are distinguished by an appraisal, accountants have permitted replacement values, when they are greater than cost values, to be entered on the books.

Cost and replacement values should be separated in the accounts. The write-up should be carried to a Plant Appreciation account or some such plant adjustment account, against which a Valuation Depreciation Reserve account is established. The net-plant appreciation should be credited to a Reappraisal Surplus or Unrealized Profit from Appreciation account.

Original cost values cannot be disturbed in the plant ledger accounts, because future depreciation charges will have to be estimated on these values for income tax purposes. The Federal government will not allow depreciation to be charged on replacement value, except that the replacement value as of March 1, 1913, may be substituted for the cost of fixed assets acquired before that date. Although a taxpayer may not take advantage in later years of his prior failure to take adequate depreciation, he is not prohibited from reducing his depreciation rates if he finds that he has underestimated the remaining useful life of the property.

The appraisal shows whether or not the depreciation taken in the past has been adequate, since the ratio of accrued depreciation on replacement values should be the same as the ratio of accrued depreciation on original cost values. For example, if the appraisal shows accrued depreciation on replacement values as 25%, and if the ratio of accrued depreciation on cost figures is only 20%, depreciation in the past has been inadequate; conversely, if accrued depreciation based on cost were 30%, the depreciation provided in the accounts on a cost basis has been excessive. The accrued depreciation shown by the appraisal report is then divided between the Valuation Depreciation Reserve and the regular Depreciation Reserve in such a manner that the two accounts will have the same percentage relationship of their corresponding asset accounts, Plant Appreciation and Plant.[5]

The following illustration will make these points clear:

[3] R. P. Marple, *Capital Surplus and Corporate Net Worth*, p. 180.
[4] *Ibid.*, p. 181.

[5] R. B. Kester, *Advanced Accounting*, Vol. II (3rd rev. ed.), p. 533.

	Original Cost	*Per Appraisal*	*Increase*
Gross Value	$500,000	$800,000	$300,000
Depreciation Reserve	100,000	200,000	100,000
Net Value	$400,000	$600,000	
Per Cent of Accrued Dep'n	20%	25%	

The following journal entry is made to reflect appraisal values:

	Debit	*Credit*
Plant Appreciation	$300,000	
Earned Surplus	25,000	
Depreciation Reserve		$ 25,000
Valuation Depreciation Reserve		75,000
Reappraisal Surplus		225,000

The original cost of the fixed assets amounted to $500,000. The appraisal showed that the replacement values should have been stated at $800,000, or an increase of $300,000, which represents the write-up or appreciation of fixed assets carried in the Plant Appreciation account. Since the ratio of accrued depreciation to replacement values as indicated by the appraisal is one-fourth or 25%, this rate determines the ratio which should be applied to the accrued depreciation on original cost. If this were done the amount of the accrued depreciation per books would show $125,000; the books show, however, that the accrued rate was only 20%, or $100,000, indicating that inadequate depreciation has been figured in the past. In order to correct this understatement of expenses, it is necessary to charge Earned Surplus for the overstated past profits and to credit the Reserve for Depreciation account for $25,000. This brings the accrued depreciation on cost up to the same ratable basis as the accrued depreciation on replacement values, or 25%. Having adjusted these items on the same percentage basis, it naturally follows that the accrued depreciation on the Plant Appreciation account also should be 25%, or $75,000 ($300,000×25/100). The amount is credited to the Valuation Depreciation Reserve and the sum of the net value of the Plant, Plant Appreciation, and the two reserve accounts should equal the net appraised value of the plant:

	Plant Account	*Plant Appreciation Account*	*Total per Appraisal*
Gross Value	$500,000	$300,000	$800,000
Depreciation Reserve	125,000		
Valuation Depreciation Reserve		75,000	
Total Reserve			200,000
Net Value	$375,000	$225,000	$600,000
Percent of Accrued Depreciation	25%	25%	25%

The reappraisal surplus is determined by subtracting the net-plant account value $375,000, from the net value as shown by the appraisal, $600,000, or a difference of $225,000.

Two questions immediately arise once plant appreciation has been established on the books. How shall depreciation on plant appreciation be handled in the cost records? And, what shall be the eventual treatment of the reappraisal surplus?

If the new valuation is what the management proposes to maintain, it follows that income should be charged with the full amount of depreciation on the new value. A company's unwillingness to absorb such a charge is alone a very good reason against the writing up of plant account.[6] Mr. William W. Werntz, chief ac-

[6] George O. May, in a letter to the members of the Committee on Accounting Procedure, American Institute of Accountants, dated October 17, 1939.

countant for the Securities and Exchange Commission, writes:

> A review of the available cases and authorities disclosed a well-defined trend among certifying accountants in favor of charging operations with depreciation on the full carrying value of assets in those cases in which new and higher values have been recorded on the books.[7]

Depreciation on the appraised value is charged to income, and no transfer of amount equal to depreciation on excess of appraisal value over cost value is transferred from reappraisal surplus to earned surplus

If one assumes in the illustration on the preceding page that remaining useful life of the plant is ten years, the annual depreciation charge amounts to $60,000 (depreciation on original cost, $37,500, plus depreciation on plant appreciation, $22,500). The depreciation reserve is credited each year with $37,500, and the valuation depreciation reserve, $22,500. Depreciation is based on the new appraisal value and eventually the total reserves will amount to $800,000. When the plant assets are retired and charged against these reserves, no balance is left in either of the four accounts: Plant, Plant Appreciation, Depreciation Reserve, and Valuation Depreciation Reserve.

In all this procedure no element of earned surplus arises. The reappraisal surplus remains at the same figure of $225,000—the amount set up at the time of the appraisal. Although this account can be used for the purpose of absorbing future write-downs as discussed on page 395, once the increased value has been collected from the customers in the form of depreciation charges embodied in the selling prices, the Reappraisal Surplus account becomes a permanent or paid-in surplus item (Capital Surplus), or the account may be converted into capital stock by means of a stock dividend. If the plant assets are replaced at the appraisal figure of $800,000, there has been no increase in the actual plant assets, but only in the monetary statement of them.

If the point of view is taken that income is charged only with the depreciation on original cost, and the reappraisal surplus is used annually to build up the valuation depreciation reserve, at the end of ten years, the reappraisal surplus is written off completely. Thus, there seems no justification for the write-up of the plant assets in the first place.

On the other hand, if income is charged with the total depreciation on appraised value, but an amount equal to depreciation on excess of appraised value over original cost is transferred annually from reappraisal surplus to earned surplus, the effect is to cancel the plant appreciation against the reappraisal surplus by way of the earned-surplus account. Thus, at the end of ten years no effect whatever is reflected upon the statement of capital investment in plant assets. Although the annual depreciation charge has been increased, this has not provided additional funds for the replacement of assets at a higher price level. Should the plant assets have to be replaced at the $800,000 amount, new capital will have to be forthcoming before the replacement can be made.

In the place of the procedure outlined above, the company may appropriate earned surplus to provide a "reserve for plant replacement," thus reducing the surplus available for dividends, and retaining sufficient capital in the business to replace the plant assets when they are retired. This method seems a round-about process for accomplishing the very thing which a permanent reappraisal surplus does originally.

Ordinarily appreciation above the original cost of plant assets should not be

[7] William W. Werntz, "An Approach to Accounting Problems," *NACA Bulletin*, Vol. xx, No. 10, sec. I (January 15, 1939), p. 583.

entered in the books. Conservatism warns management not to lose sight of original cost values. For income tax purposes, depreciation expenses are calculated on the basis of original cost or March 1, 1913 replacement values. General instances, however, do not apply in all cases. Sometimes a write-up above original cost is justifiable even on conservative grounds. Fixed assets acquired in bankruptcy sales, receiverships, foreclosures, and quasi-reorganizations all require conservative appraisals resulting in replacement values higher than original cost values. Whenever management accepts these appraisal values and wishes to maintain the higher valuation in the accounting records, income should be charged with depreciation on the appraisal values. The reappraisal surplus becomes a permanent increase in the net worth of the company and should not be transferred to earned surplus as depreciation on appreciation is absorbed in operating expenses.

ACCOUNTING CASES

ALLAN J. FISHER

AKRON BRASS MANUFACTURING COMPANY, INC.: REORGANIZATION; APPRECIATION OF FIXED ASSETS; PARENT AND UNPROFITABLE SUBSIDIARY

The history of the Akron Brass Manufacturing Company, Inc. presents some rather interesting features in conjunction with a very simple reorganization, the appreciation of fixed assets (and a brief experience with a single, unprofitable subsidiary). The company was organized in Ohio on July 6, 1935, to take over the business of The Akron Brass Manufacturing Company. The latter had been incorporated on December 26, 1919, and continued as a going concern until July 8, 1935, when all of its assets were transferred to, and all of its liabilities assumed by, the Akron Brass Manufacturing Company, Inc. The corporate existence of the predecessor company was terminated on October 9, 1935.

The Akron Brass Manufacturing Company, Inc., is principally engaged in the manufacture, sale and assembly of brass and alloy goods for fire and mill equipment. Its products include nozzles, hose couplings, siphons, coupling expanders, fire hose test pumps, and other fire fighting equipment. An abortive attempt to expand its activities through a wholly owned subsidiary was made in 1937. The corporation has a plant in Wooster, Ohio, and service branches in Chicago and New York.[1]

The balance sheet of The Akron Brass Manufacturing Company on July 8, 1935, immediately prior to the reorganization appears on the following page:[2]

The only change in the balance sheet of the successor corporation as of the beginning of business July 8, 1935, was in the number of shares of capital stock authorized and issued. The number of shares authorized was increased from 25,000 to 50,000 and the new shares were issued to the shareholders of the predecessor corporation on the basis of two new shares for each share of the old stock held. A treasury stock transaction as of July 8, 1935, apparently involving 45 shares of The Akron Brass Manufacturing Company stock, which however was not recorded until July 31, 1935, resulted in the issuance of only 49,700 shares of the newly authorized stock. This omitted transaction was taken care of subsequently by an adjustment of the predecessor corporation's surplus.[3] The net-worth section of the Akron Brass Manufacturing Company, Inc., as of the beginning of business July 9, 1935, consequently showed:

CAPITAL		
Represented by:		
50,000	Shares authorized, common no par value	
300	Shares unissued..........	
49,700	Shares issued and outstanding..................	$ 91,000.00
EARNED SURPLUS......................		29,150.00
TOTAL NET WORTH..................		$120,150.00

Two hundred of the three hundred unissued shares were sold for $1,000 cash on July 8 or 9, 1935,[4] leaving one hundred shares unissued on December 31, 1935.

However, while the balance sheet as of July 8, 1935, shows no very significant change from the corresponding statement of the predecessor corporation, the balance sheet as of December 31, 1935, also reproduced herewith, is materially different.[5]

The most striking feature is the reflection

[1] SEC File 2-2312-1; Standard Corporation Records.
[2] SEC File 1-2649-1.
[3] See detail of these adjustments, cited below
[4] The corporation's reports to the Securities and Exchange Commission are in conflict as to the exact date.
[5] SEC File 1-2649-1.

BALANCE SHEET

THE AKRON BRASS MANUFACTURING COMPANY (THE PREDECESSOR CORPORATION)

As of the close of business July 8, 1935

ASSETS

Current Assets			
Cash:			
Cash on hand	$ 75.00		
Cash in bank	6,505.88	$ 6,580.88	
Investments—(cost)		23,549.48	
Accounts Receivable—Trade	$25,376.33		
Less—Reserve for doubtful	6,798.14	18,578.19	
Inventories: (Note A)			
Raw materials	$10,107.51		
Merchandise for resale	11,487.10		
Work in Process	13,945.85		
Factory supplies	1,434.86		
Finished product—consigned	3,061.09	40,036.41	
Total Current Assets			$ 88,744.96

Permanent Assets:	Schedule II Book Value	Schedule III Depreciation Reserve		
Land			$ 2,800.00	
Buildings	$40,024.37	$15,774.72	24,249.65	
Machinery & Equipment	33,292.37	17,507.28	15,785.09	
Office Furniture & Fixtures	1,836.85	1,232.38	604.47	
Vapor nozzle, dies Etc.,	6,423.00	—0—	6,423.00	
Display Truck	713.50	389.54	323.96	
Total	$82,290.09	$34,903.92	$47,386.17	
Total Permanent Assets				50,186.17
Deferred Charges:—Insurance				758.47
TOTAL ASSETS				$139,689.60

LIABILITIES

Current Liabilities:			
Accounts Payable		$ 4,745.39	
Accruals:			
Wages	$ 3,284.90		
Federal Income Tax	11,113.21		
Real estate Tax	113.68		
Personal Property tax—Ohio	176.42		
Capital Stock Tax	106.00	14,794.21	
Total Current Liabilities			$ 19,539.60

NET WORTH

Capital:			
Represented by:			
Authorized . . . 25,000 Shares, Common no par			
Unissued . . . 105 Shares, common no par			
Issued . . . 24,895 Shares & Outstanding		$91,000.00	
Earned Surplus		29,150.00	
Total Net Worth			120,150.00
TOTAL LIABILITIES AND NET WORTH			$139,689.60

General Note: The accounts and individual amounts comprising this Exhibit are as shown by the Company's books of account and record without audit adjustment and Exhibit is subject to the Auditors' Certificate and opinion as included elsewhere in this report.

Note "A"—The inventories included herein are not the result of a physical inventory but rather a calculated inventory with the production and sales records as the basis of said calculation.

Note "B"—At date of this balance sheet, the Federal Internal Revenue had not examined the Federal Income Tax Return for 1934. The examination thereof during 1936 disclosed an assessment in the approximate amount of $340.00. No provision therefor has been made in this Exhibit.

BALANCE SHEET

AKRON BRASS MANUFACTURING COMPANY, INC.—(THE REGISTRANT)

As of December 31st, 1935

ASSETS

Current Assets:				
Cash:				
On hand		$ 75.00		
In bank		497.93	$ 572.93	
Investments:				
Stocks of Domestic Corp'ns—cost		$ 24,092.80		
Municipal Bond—cost		500.00		
City Tax Warrant		106.50	24,699.30	
Accounts Receivable:				
Customers	$ 37,080.87			
Accts. payable debit balances	6.20	$ 37,087.07		
Less—Reserve for doubtful Accts.		4,283.55	32,803.52	
Inventories: (Note A)				
Raw materials		$ 19,184.22		
Factory supplies		1,668.50		
Work in process:				
Materials & supplies capitalized	$ 7,784.64			
Labor capitalized	3,912.19	11,696.83		
Finished product—consigned		2,191.04		
Merchandise for resale		21,054.33	46,794.92	
Other:				
Dividends receivable		$ 420.00		
Deposit—City of Cincinnati, Ohio		375.00		
Employees—receivable		50.01	845.01	
Total Current Assets				$105,715.68
Cash Surrender Value of Life Insurance				3,808.99
Permanent Assets:				

	Per Schedule II Per Books	Per Schedule II Appreciation	Total		
Land				$ 2,800.00	
Buildings	$43,322.01	$ 9,582.76	$ 52,904.77		
Machinery & Equipment	38,456.17	57,384.70	95,840.87		
Furniture & Fixtures	2,226.91	2,817.12	5,044.03		
Patterns	—0—	82,860.00	82,860.00		
Vapor nozzle, dies etc.	7,591.00	—0—	7,591.00		
Total	$91,596.09	$152,644.58	$244,240.67		
Less—Reserve for Depr., Sch. 3	36,813.21	5,952.33	42,765.54		
Total	$54,782.88	$146,692.25	$201,475.13	201,475.13	
Total Permanent Assets					204,275.13
Other Assets:—Patents and Trademarks					1.00
Deferred Charges to Operations					1,228.46
TOTAL ASSETS					$315,029.26

LIABILITIES

Current Liabilities:					
Note payable, due 1-20-36, The Com'l. Banking & Trust Co.				$ 3,000.00	
Accounts payable—trade				10,664.49	
Accruals:					
Federal Income Tax, 1935		$ 9,906.47			
Real estate Tax, 1935		240.99	$10,147.46		
Wages			4,166.69		
Royalties			1,249.75		
Commissions			918.34		
Interest			5.00	16,487.24	
Accounts Receivable credit balances				22.80	
Total Current Liabilities					$ 30,174.53

NET WORTH

Capital					
Represented by:					
50,000 Shs. Authorized, common no par value					
49,700 Shs. issued & Outstanding, 7-8-35			$91,000.00		
200 Shs. issued & sold 7-8-35			1,000.00		
49,900 Shs. issued & outstanding			$92,000.00		
Capital Surplus:					
Appreciation of Permanent Assets				$146,692.25	
Patents and Trademarks				1.00	
Total				$146,693.25	
Earned Surplus					
As of 7-8-35	$29,150.00				
Adjustments	5,937.54	$35,087.54			
Profit for period 7-8-35 to 12-31-35	$17,311.48				
Less: Dividends Pd.	6,237.54	11,073.94	46,161.48	138,161.48	284,854.73
Total Liabilities and Net Worth					$315,029.26

Note "A"—Physical inventory was taken under the direction of the management as of December 31, 1935, and we were informed that prices used were either cost or market, whichever, lower. We made no verification either of quantities or prices, but did however, receive a certificate, signed by a responsible official of the Company, as to the quantities, prices, and salability therefor. The mathematical computations were thoroughly checked by us. Our examination disclosed that a carload of aluminum ingots was purchased and received during the month of December, 1935 but was not recorded on the Company's books of account as of December 31, 1935. We have made proper provision in our report for the receipts of said material in the amount of $7,680.00.
Note "B"—This exhibit is subject to the comments contained in Auditors' Certificate and opinion included elsewhere in this report.

in the balance sheet of the revaluation upwards of "permanent assets". The appreciation of buildings, machinery and equipment, and office furniture and fixtures was based upon an appraisal made by the Manufacturer's Appraisal Co., under date of February 16, 1934,[6] while the appreciation of patterns was based upon a valuation submitted by Mr. J. C. Schellin, who was Secretary, Assistant Treasurer, and General Manager of the company.

The entry effecting the revaluation as of December 31, 1935, is explained by the company as follows:[7]

Accounts Affected	*Debits*	*Amount Credits*
Appreciation of permanent assets, buildings	$ 9,582.76	0
Appreciation of permanent assets, machinery and equipment	57,384.70	0
Appreciation of permanent assets, office furniture and fixtures	2,817.12	0
Appreciation of permanent assets, patterns	82,860.00	0
Appreciation of permanent assets, reserve for depreciation	0	5,952.33
Totals, Note A	$152,644.58	$ 5,952.33
Patents and trade marks	1.00	0
Capital surplus through appreciation	0	146,693.25
Total	$152,645.58	$152,645.58

Note A—The individual amounts comprising the total debits $152,644.58 and credits, $5,952.33 are entered in one account in the General Ledger of the Akron Brass Manufacturing Company, Inc. Said account is titled "Appreciation of Permanent Assets." These individual balances are not entered in the accounts containing the original book balances of aforementioned assets.

Other changes of significance may be noted in the balance sheet as of December 31, 1935. The setting up of the cash surrender value of life insurance, not previously reflected on the books, is associated with the adjustment by $5,937.54 of the surplus taken over from the predecessor company. The detail of these adjustments, as explained later by the company was:[8]

Items Increasing Surplus		
Decrease in Reserve for Doubtful Accounts		$2,374.31
Setting up of cash surrender value of life insurance		3,539.61
Expenses—charged to prior period not applicable		
Life insurance premiums		398.05
General insurance premiums		152.69
Industrial insurance premiums		239.46
Capital stock tax		106.00
Personal property tax—Ohio		176.41
Dividends receivable as of 7/8/35, not recorded		125.00
Total of items increasing surplus		$7,111.53
Items Decreasing Surplus		
Prior period depreciation	$379.55	
Prior period taxes—real estate	119.44	
Purchase of treasury stock—7/8/35, recorded 7/31/35	675.00	
Total of items decreasing surplus		1,173.99
Net increase in surplus		$5,937.54

The net credit to surplus of $5,937.54 added to the prior balance of $29,150.00 gives $35,087.54, which in subsequent balance sheets is labeled "Acquired Surplus" and is kept separate from surplus earned after incorporation of the successor company.

When appreciation is entered on the books of a company, the intention may be to affect balance-sheet values only, or to affect the profit-and-loss statement also through increased depreciation charges.

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[6] A subsequent registration statement filed by the Akron Brass Manufacturing Company, Inc., contained the following letter written by the appraisers:

Gentlemen:

"We hereby consent to the use of our Appraisal Report as of September 20, 1929, and our Supplementary Report as of February 16, 1934 of the Buildings, Machinery and Equipment of your plant at Wooster, Ohio, in connection with a Registration Statement to be filed by your Corporation with the Securities and Exchange Commission at Washington, D. C.

"The 1929 Report comprised a detailed appraisal of Buildings, Machinery and Equipment, priced at 1929 reproduction costs, less specific accrued depreciation. The 1934 Supplementary Report comprised a personal inspection and compilation of lists of additions, deductions and changes in the assets between September, 20, 1929 and February 16, 1934; and the compilation of new summaries by classification totals as affected by the additions, deductions and changes, and by changes in costs of reproduction and accrued depreciation between 1929 and 1934.

Respectfully submitted,

THE MANUFACTURERS' APPRAISAL COMPANY"

SEC File 2-2312-1

[7] Ibid.

[8] SEC File 1-2649-1, Schedule VII, Earned Surplus.

The former policy has been the one adopted by the Akron Brass Company. In 1936 the company provided depreciation on a straight-line basis, using rates "approved" by the Department of Internal Revenue, and making no provision for depreciation on appreciation, nor for a reduction of the capital surplus which had been created by the appreciation of the fixed assets.[9] However, in 1937 the Board of Directors voted to reduce the original amount of appreciation ($146,692.25) by 10% per annum, beginning in 1937, and this policy was continued in 1938 and 1939. According to the company "This reduction was recorded by crediting the fixed-asset accounts originally appreciated and charging the total adjustment direct to 'Capital Surplus—Arising through unrealized Appreciation—Fixed Assets'."[10] The annual depreciation charge in the profit-and-loss statement has never been affected by the upward revaluation of assets.

No specific reason for the revaluation seems to have been advanced by the company. However, the action was followed within a few months by registration with the Securities and Exchange Commission of 8,700 shares of stock, in the hands of shareholders and officers of the company, to be disposed of through Gillis Wood and Company as underwriters. The stock so registered represented in each instance considerably less than 50% of the total holdings of such officer, and was to be offered to the public at $12.50 per share, with the underwriters having the right to purchase the stock at $10.00 per share.[11] It would perhaps not be unwarranted to assume that some connection existed between the revaluation and the registration of these securities for sale. The net worth of the corporation on July 8, 1935, immediately after reorganization, was $120,150.00 and the book value per share was $2.42 ($120,150.00+49,700 shares), and on December 31, 1935, the net worth was $284,854.73 and the book value was $5.71 per share ($284,854.73+49,900 shares). The increase in net worth between the two dates of $164,704.73 was accounted for as follows:

Capital surplus arising from appreciation of fixed assets	$146,692.25
Capital surplus from patents and trademarks	1.00
Capital stock sold for cash	1,000.00
Adjustments of acquired surplus	5,937.54
Undistributed earnings for period 7/8/35 to 12/31/35	11,073.94
Total	$164,704.73

The prospectus covering the registration of the above-mentioned securities (it should be noted that no new financing by the company was involved) was dated July 31, 1936, and contained a balance sheet as of March 31, 1936. The only change in net worth on March 31, 1936, as compared with December 31, 1935, was an increase of $12,562.35 representing the net profit for the first three months of 1936, making the total net worth $297,417.08. It is evident that the major changes in net worth occurred between July 8, 1935, and December 31, 1935, and that the increase of $146,592.25 from appreciation was by far the most significant of such changes. The Akron Brass Manufacturing Company, Inc., has, however, clearly indicated the steps taken in recording appreciation, has kept appreciation separate from the cost of the assets, has written down the appreciation annually (except in the first year), and has based its depreciation charges upon cost rather than appreciated values. These measures represent a rather conservative handling of the appreciation problem, and under the circumstances, probably no serious objection to the treatment described could be raised.[12]

[9] SEC File 1-2649-2.

[10] *Ibid.*

[11] SEC File 2-2312-1 (Form A-2).

[12] The company has also been able to earn a rather respectable rate of return on the enhanced amount of net worth, as for example $17,311.48 for the six months from July 8, 1935, to December 31, 1935, and $27,553.72

It may also be of some value to reproduce the profit-and-loss statements of Akron Brass Manufacturing Company, Inc., and of its wholly owned subsidiary, U. S. Fire Equipment Company, for the year 1937. The profit-and-loss statement of the parent company, which is first presented[13] (see next column) is rather interesting in showing separately under cost of goods sold the cost of materials, direct labor, manufacturing expense, and inventory-valuation loss. The items presented under Other Income and Other Income Deductions, particularly the treatment of the loss sustained from the wholly owned subsidiary and the explanation contained in the footnote are significant. While, as stated in such footnote, the loss of the subsidiary was not consolidated in the parent company statement, the same effect was attained by charging off the original investment in the subsidiary and the loss on accounts receivable due from the subsidiary, the sum of these losses being equal to the loss shown by the profit-and-loss statement of the subsidiary. In order to complete the picture, the profit-and-loss statement of the subsidiary is also reproduced.[14]

for the year 1937 even after incurring a $16,696.38 loss from its subsidiary.

In connection with the aspects of appreciation presented here, the following quotation from Paton and Littleton's "Introduction to Corporate Accounting Standards" (American Accounting Association, 1940), p. 130, may be appropriate:

"Revision of recorded plant cost is urged by appraisers on many grounds. Among special occasions for valuation are imminence of change of ownership, reorganization, pledging of assets in financing, regulation of rates, measurement of cost under 'fair trade' acts proving losses under insurance contracts, determining amount of insurance to be carried, levying property taxes and estate duties, etc. In general there can be no objection to careful appraisals made in such connections, as the available records, regardless of how well kept, may be inadequate for the purpose in hand. Indeed, valuations on these special occasions need not be considered to violate the cost standard, and the results of the valuation need not be recorded in the accounts except when they become the basis of an actual cost (or, perhaps, an implied cost, in the case of reorganization and new financing)."

[13] SEC File 1-2649-2. [14] SEC File 1-2649-2.

The accompanying note gives a succinct description of the course of ownership and dissolution.

PROFIT AND LOSS STATEMENT
AKRON BRASS MFG. COMPANY, INC.—(REGISTRANT)

For year ended December 31st, 1937

Gross sales—less discounts allowances, etc.		$351,035.96
Cost of goods sold:		
Cost of Materials, etc. used	$76,064.06	
Direct labor	79,497.77	
Manufacturing expense	61,143.23	
Inventory valuation loss	11,533.75	228,238.81
Gross profit		$122,797.15
Operating expenses:		
Selling, general and administrative expenses	$77,773.23	
Provision for doubtful accounts	—0—	
Other general expenses	3,931.49	81,704.72
Operating profit		$ 41,092.43
Other income:		
Dividends—(See schedule XI)	$ 1,722.50	
Profit on sale of securities (Note B)	5,007.01	
Miscellaneous other income	2,771.09	9,500.60
		$ 50,593.03
Income deductions:		
Loss on sale of securities (Note B)	$ 457.82	
Miscellaneous income deductions:		
Loss of original investment in wholly owned subsidiary—U. S. Fire Equipment Company —(Note A)	5,869.79	
Loss on accounts receivable due from wholly owned subsidiary—U. S. Fire Equipment Company (Note A)	10,826.59	
Interest—on notes payable	1,887.08	19,041.28
Net income—Before provision Federal Income and Excess Profits taxes		$ 31,551.75
Provision for federal taxes—Federal Income and Excess Profits		3,998.03
Net income to surplus (See Schedule IX)		$ 27,553.72

Note A—The operations of the Registrant's wholly owned subsidiary, The U. S. Fire Equipment Company, have not been consolidated in this exhibit but are separately shown by exhibit "C." This subsidiary operated from January 5, 1937 to November 26, 1937. The loss sustained by the subsidiary namely $16,696.38 has been absorbed by the Registrant in this exhibit as follows:

"Loss of original investment in wholly owned subsidiary—U. S. Fire Equipment Company"	$ 5,869.79
"Loss on accounts receivable due from wholly owned subsidiary—U. S. Fire Equipment Company	10,826.59
TOTAL	$ 16,696.38

Note B—Specific certificate cost method was used in computing the profit or loss through sale of securities as shown herein.

Note—Schedule X included in this annual report sets forth detail as to maintenance and repairs, depreciation of fixed assets, taxes, royalties, etc.

Note—This Statement of Profit and Loss is subject to the comments included elsewhere in this annual report.

The story was not completely told in 1937. In the profit-and-loss statement of the Akron Brass Company for 1938 under Income Deductions was an item of $3,220.85 labeled "Loss on clothing inventory (of subsidiary eliminated prior to December 31, 1937)."[15] At least the Akron Brass Company was not remiss in discovering it had made a bad bargain, and the promptness and decisiveness of its action in dissolving an unprofitable subsidiary might be worthy of emulation in other quarters.

STATEMENT OF PROFIT AND LOSS AND DEFICIT
U. S. FIRE EQUIPMENT COMPANY—WHOLLY OWNED SUBSIDIARY—AKRON BRASS MFG. COMPANY, INC.—(REGISTRANT)

From Date of Purchase—January 5th, 1937 to date of Abandonment—November 26th, 1937

Gross sales—less discounts allowances, etc.			$37,184.84
Cost of goods sold			28,235.14
Gross profit			$ 8,949.70
Expenses:			
Selling—general and administrative			21,754.51
Operating loss			$12,804.81
Other deductions:			
Salesmen's advances charged off	$1,997.07		
Prepaid items charged off	1,469.96		
Bad debts charged off	832.51		
Loss on sale of capital assets	31.06		
Miscellaneous	296.33	$4,626.93	
Other income—Discounts allowed		735.36	3,891.57
Net loss			$16,696.38
Deficit—January 5th, 1937			1,830.21
Deficit—November 26th, 1937			$18,526.59

No schedules have been included in this annual report in supporting detail of this exhibit nor has Balance Sheet been included. The Registrant, the Akron Brass Mfg. Company, Inc. purchased the total outstanding shares of the U. S. Fire Equipment Company as of January 5th, 1937 for $5,869.79. The subsidiary operated until November 26th, 1937 as a sales organization for products manufactured by the Registrant, for other manufactured fire fighting equipment, supplies and firemen's clothing. As of November 26th, 1937 the U. S. Fire Equipment Company was discontinued and the assets thereof were purchased by the Registrant by liquidation of a portion of the intercompany obligations and assumption by the Registrant of the liabilities of the Subsidiary. After this transaction was completed the Subsidiary showed a deficit of $18,526.59. Consequently the stock ownership in the subsidiary was charged off as worthless by the Registrant and on December 15th, 1937 dissolution proceedings were instigated in connection with the charter of the Subsidiary.

[15] *Ibid.*

GIMBEL BROTHERS, INC.: APPRECIATION OF FIXED ASSETS; EARNINGS OF SUBSIDIARIES; RETAIL STORE ACCOUNTS

Recent financial statements of Gimbel Brothers, Inc. disclose several features of interest which may be discussed under the three general headings of appreciation of fixed assets, handling of earnings of subsidiaries, and a group of miscellaneous items of significance, several of them characteristic of a large retail merchandising establishment. The business of Gimbel Brothers, Inc. had its inception in Vincennes, Indiana, in 1842, but the present parent company was not incorporated until August 22, 1922, in the State of New York. The parent company, Gimbel Brothers, Inc., and the operating subsidiaries Saks & Company, Kaufman and Baer Company, and Saks & Company, Inc. (Md.), operate seven large stores in metropolitan areas such as Milwaukee, Philadelphia, Pittsburgh, and New York City, as well as in resort cities such as Palm Beach and Miami Beach. The business is primarily of department-store character, including the selling of a complete line of wearing apparel, dry goods, house furnishings, etc., in conjunction with the opera-

tion of a number of restaurants and other service departments. There are also a number of wholly owned subsidiary realty companies, as well as a bank (Gimbel Brothers Bank and Trust Company) which is maintained as a service to customers in Philadelphia.[1]

I. Appreciation of Fixed Assets

The books of the corporation reflect two appraisals, both dating back to the early twenties. Immediately after incorporation in 1922, Gimbel Brothers, Inc. acquired the net assets of two predecessor corporations and two subsidiary companies. The vendors' valuations of property, leaseholds, leasehold improvements, and equipment were accepted by the purchasing corporation, with the exception of real estate in Milwaukee, the value of which was increased $871,783.33, and of leaseholds which were valued at $415,000.00. These upward revisions were based upon appraisals by outsiders, and depreciation on both the valuations continued from the predecessor books and on the increased valuations referred to has been charged against profits, since all such figures are regarded as representing cost.[2]

In 1924 another appraisal occurred, and the procedure and effect are described by the corporation as follows:[3]

As at January 31, 1924 the land, buildings, leasehold improvements and leaseholds of the Registrant and its subsidiary companies (with the exception of properties and improvements recently purchased or in course of construction) were appraised by outsiders and their appraisal showed an appreciation of $10,228,387.11. The books were adjusted to reflect the higher values, the increase of $10,228,387.11 being credited to "Surplus from appreciation of real estate and leaseholds." Store fixtures and equipment and delivery equipment were not appraised. The buildings, leasehold improvements and leaseholds appraised have since been depreciated annually and the portion of the depreciation applicable to cost has been deducted from profits while the portion applicable to the appreciation has been deducted from "Surplus arising from appreciation of real estate and leaseholds."

These two examples illustrate the difference in accounting procedure between an appraisal made at the time newly acquired assets are placed on the books, and an appraisal made at some time subsequent to the acquisition of the assets. Ih the former instance, the appraised value was considered to be "cost," and depreciation was charged to expense. In the second instance, although orthodox accounting calls for the creation of a revaluation surplus account for the excess of the appraised value over cost, the division of the depreciation charge into two parts, one representing depreciation on cost, charged against profits, and the other representing a reduction of revaluation surplus, diverges from what is now regarded as a commonly accepted accounting principle.[4] For the year ended January 31, 1940, the amount of depreciation charged to costs or income was $886,688.01 and the amount charged to surplus from appreciation of real estate and leaseholds was $180,910.91, classified as follows:[5]

On Assets Used in Store Operations	*Charged to costs or income*	*Charged to surplus from appreciation of real estate and leaseholds*
On Assets Used in Store Operations		
Buildings and building equipment on owned land	$859,884.82	$178,973.88
Leaseholds	4,549.80	791.66
On Assets Not Used in Store Operations		
Buildings and building equipment on owned land	22,253.39	1,145.37
Totals	$886,688.01	$180,910.91

[1] SEC File 1-280-1.

[2] SEC File 1-280-2, Note C to Consolidated Profit and Loss Statement, January 31, 1940.

[3] *Ibid.*, 1940 Statements, p. 29.

[4] Proposition, Statement of American Accounting Association XI, ACCOUNTING REVIEW.

[5] SEC File 1-280-2, Schedule III—Consolidated Reserves for Depreciation and Amortization of Fixed Assets (January 31, 1940).

Exhibit I

Gimbel Brothers, Inc.

(A New York Corporation)

Profit and Loss, Year Ended January 31, 1940

Reconciliation with surplus (Schedule IX):			
Net profit of registrant			$ 364,294.72
Appreciation (net) of investments in subsidiary companies by equity in earnings or losses for fiscal year:			
Domestic subsidiary companies (eliminated in consolidation)		$1,202,513.77	
Deduct dividends received from companies which had earned surplus since acquisition, included above		175,208.05	
		$1,027,305.72	
Gimbel Brothers Bank and Trust Company (not eliminated in consolidation)		10,694.65	
			1,038,000.37
Excess of reserve for possible assessment of taxes not now required			171,516.45
Adjustment with respect to leasehold improvements of a subsidiary company			220,840.27
			$1,794,651.81
Distributed as follows:			
Earned surplus—parent company:			
Net profit of parent company, as above		$ 364,294.72	
Profits of subsidiary companies—not in excess of losses previously charged to earned surplus of parent company:			
Consolidated	$470,279.21		
Gimbel Brothers Bank and Trust Company, not consolidated	10,694.65		
	$480,973.86		
Less losses of subsidiary companies having a prior deficit—consolidated	6,360.69		
Net amount		474,613.17	
Excess of reserve for possible assessment of taxes not now required		67,641.81	
Adjustment with respect to leasehold improvements of a subsidiary company		220,840.27	
			$1,127,389.97
Surplus arising from appreciation of investments in subsidiary companies by amounts of undistributed earnings since acquisition:			
Profits of subsidiary companies which have undistributed earnings since acquisition	$738,595.25		
Less dividends paid	175,208.05		
		$ 563,387.20	
Excess of reserve for possible assessment of taxes not now required		103,874.64	
			667,261.84
			$1,794,651.81

The total amount of appreciation from the 1924 appraisals still on the books on January 31, 1940, was $9,808,680.79, against which there were reserves for depreciation of $2,200,032.02, leaving net unamortized appreciation of $7,608,648.77. Approximately 60% of this amount, or $4,645,109.80 represented appreciation on land, which ordinarily is not subject to depreciation or amortization.[6]

II. Earnings of Subsidiary Companies

The accompanying statement,[7] Exhibit I, representing a reconciliation of profit and loss with surplus, partially explains the method used by the parent company in handling earnings of subsidiary companies. A footnote to the statement describes the

[6] *Ibid.*, Schedule II—Consolidated Property, Plant and Equipment, January 31, 1940.

[7] *Ibid.*

procedure as follows:

> It has been the consistent practice of the registrant to appreciate or depreciate its investments in subsidiary companies annually by its proportionate share of the profits or losses of such companies. Such appreciation, while included in this statement as a footnote, is credited to "Surplus arising from appreciation of investments in subsidiary companies by amounts of undistributed earnings." For depreciation of the investment in a company having undistributed earned surplus since acquisition, a reduction of previous appreciation is made; on the other hand, depreciation of investments in subsidiary companies having no undistributed earned surplus is treated as a direct charge against the registrant's earned surplus.[8]

While this note outlines in general the procedure followed by the company, it does not provide a complete explanation of the statement to which it is attached. For example, the footnote implies that the entire equity in the earnings of subsidiary companies is credited to "Surplus arising from appreciation of investments in subsidiary companies," yet the net appreciation of investments in subsidiary companies of $1,202,513.77 is divided in Exhibit I between "Earned surplus" of the parent company and "Surplus arising from appreciation of investments in subsidiary companies."

For further enlightenment on this point, it is necessary to turn to the schedule of surplus of the parent company, the pertinent part of which is reproduced in Exhibit II.[9] This schedule reveals that earned surplus is made up of a positive account, labeled "Parent company items" and a contra account "From depreciation of investments in subsidiary companies by amounts of losses." Reduction of investments in subsidiary companies having no undistributed earned surplus is charged against this contra account, rather than directly against parent-company earned surplus. Moreover, this does not necessarily mean a permanent reduction of parent-company earned surplus, as the language of the note quoted above appears to indicate. Of the $1,202,513.77 designated in Exhibit I as appreciation of investments in subsidiary companies by equity in earnings, $463,918.52[10] was used to reduce the contra account, which of course had the effect of increasing earned surplus by that amount. The remaining $738,595.25 was added to "Surplus arising from appreciation of investments in subsidiary companies." This use of a contra account is perhaps logically a counterpart of the setting up of a surplus from appreciation of investments, and charging subsequent losses of the same companies to such surplus. However, dividing the explanation of the handling of subsidiary profits and losses between two statements, even though tied together by cross references, does not serve to clarify an already complex accounting procedure. It would seem that stockholders and other readers of the financial statements are entitled to a more complete, understandable statement of policy, preferably to be found in a single source.

The contra account was likewise reduced by an adjustment of $220,840.27 with respect to leasehold improvements. On the other hand, an adjustment of the reserve for taxes resulted in increasing the contra account by $19,436.00, and increasing parent company items by $87,077.81[11] and surplus arising from appreciation of investments in subsidiary companies by $103,874.64. In the parent-company balance sheet as of January 31, 1940, surplus

[8] *Loc. cit.*

[9] SEC File 1-280-2, Schedule IX—Surplus, January 31, 1940.

[10] This is made up of $470,279.21 profits of subsidiary companies not in excess of losses previously charged to earned surplus of parent company, less $6,360.69 representing losses of subsidiary companies having a prior deficit. See Exhibit I.

[11] In Exhibit I a net increase in earned surplus of $67,641.81, or the difference between $87.077.81 and $19,436.00, is shown.

Exhibit II
Gimbel Brothers, Inc.
(A New York Corporation)
Schedule IX—Surplus
Year Ended January 31, 1940

	Earned surplus: *Total*	Earned surplus: *From depreciation of investments in subsidiary companies by amounts of losses*	Earned surplus: *Parent company items*	*Surplus arising from appreciation of investments in subsidiary companies*
Balance at beginning of the fiscal year, as per accounts	$2,199,539.01	$2,026,201.47*	$4,225,740.48	$ 616,541.17
Net profit from profit and loss statement	364,294.72	—	364,294.72	—
Appreciation, per profit and loss, of investments in:				—
Consolidated subsidiary companies' capital stock	463,918.52	463,918.52	—	738,595.25
Deduct appreciation of investments in subsidiaries realized in the amount of dividends paid during year out of earned surplus since acquisition and included in profit of parent company	—	—	—	— 175,208.05*
Gimbel Brothers Bank and Trust Company, capital stock	10,694.65	784.65	9,910.00	—
Reclassification for dividends received from subsidiary not having earned surplus since acquisition	—	14,000.00*	14,000.00	—
Other additions to surplus:				
Transfer because of conversion of deficit of a subsidiary company into a surplus	92.85*	92.85*	—	92.85
Excess of stated value over cost of $6 cumulative preferred stock repurchased	—	—	—	—
Excess of reserve for possible assessment of taxes not now required	67,641.81	19,436.00*	87,077.81	103,874.64
Adjustment with respect to leasehold improvements	220,840.27	220,840.27	—	—
	$3,326,836.13	$1,374,186.88*	$4,701,023.01	$1,283,895.86
Deductions from surplus:				
Dividends—$6 cumulative preferred stock, paid in cash, at rate of $6.00 per share	$1,181,850.00	$ —	$1,181,850.00	$ —
Total deductions from surplus	$1,181,850.00	$ —	$1,181,850.00	$ —
Balance at close of fiscal year	$2,144,986.13	$1,374,186.88*	$3,519,173.01	$1,283,895.86

* Contra.

was composed of the following items:

Earned surplus	$ 2,144,986.13[12]
Surplus from appreciation of investments in subsidiary companies (by the amount of the net undistributed earnings of subsidiary companies since acquisition)	1,283,895.86
Paid-in surplus	13,668,827.07
Surplus from appreciation of real estate and leasehold (of registrant and subsidiary companies)	7,608,648.77
Total surplus	$24,706,357.83

[12] This is the net difference between parent company items and the contra account.

III. Sundry Items of Interest in Current Financial Statements[13]

(1) The list of investments in the balance sheet on January 31, 1940, consisted of the following:

Capital stock of Gimbel Brothers Bank and Trust Company at equity in net assets	$ 278,198.47
Real estate acquired under foreclosure of mortgages and mortgage receivable—at cost or lower	291,109.75

[13] SEC File 1-280-2, Consolidated Balance Sheet, January 31, 1940, and Explanatory Notes with Respect to Consolidated Balance Sheet, January 31, 1940.

New York City World's Fair debentures and other advances in connection with the Fair	70,676.00
Due from executives, arising from sale of common stock of the Company previously acquired by Gimbel Brothers Management Corporation.	38,593.77
Securities of wholly owned foreign subsidiary companies—at cost (not consolidated)	13,289.22
Deposits with mutual and reciprocal insurance groups, miscellaneous securities and miscellaneous balances	193,990.86
Land, buildings and building equipment on owned land, acquired for business purposes but not now used in store operations—at values as appraised in 1924 with subsequent additions at cost	
Land	2,638,640.77
Buildings and building equipment less depreciation of $363,487.48.	456,270.58
	$3,975,769.42
Less reserve for losses	170,000.00
	$3,805,769.42

The company "makes no representation as to the present realizable value of these assets,"[14] and the list includes several unusual examples of investments, such as the sums due from executives, as well as the more usual investments in securities.

(2) The list of investments includes deposits with mutual and reciprocal insurance groups. The latter method of carrying insurance results in a contingent liability, and while the company states that past experience indicates such liability is remote, a reserve of $127,044.88 has been set up to take care of it.

(3) Current assets include customers' accounts arising from instalment sales, the due date of some of which is in excess of one year, and in the case of piano and electric refrigerator accounts may be in excess of two years. Trade accounts and notes receivable also include amounts due from officers and directors arising from the sale of merchandise in the ordinary course of business. The inclusion of these items as current assets and trade accounts receivable respectively is justified as being "in accordance with the trade practice."[15]

(4) Profits on instalment sales are not deferred until collections are made, but are taken up in the year of sale, accompanied by the provision of reserves for collection expenses, refundable carrying charges, and loss of gross margin on sales returns. This represents one, and perhaps the simpler, of the two methods of handling profits on instalment sales which are acceptable for income-tax purposes.

(5) Inventories in general are valued by the retail method, including deductions for trade and cash discounts, but there are several exceptions. Merchandise just received and not yet retailed, merchandise in other than retail departments, and merchandise in transit is valued on the basis of cost less discounts. In addition, in some instances a deduction is made for estimated price reductions in excess of normal.

(6) On January 31, 1939, the cost of New York World's Fair debentures and other advances in connection with the Fair was shown as $308,001.00. One year later this item was included among investments at $70,676.00 (see list above). After taking into consideration collections of principal and interest, a loss of $187,595.29 was anticipated on these debentures and advances, of which one half or $93,797.65 was charged against profits of the year ended January 31, 1940, and one half or $93,797.64 carried as a deferred charge to be written off against profits in the second year of the World's Fair.

(7) Buildings, building equipment on leased land, and improvements to leased buildings are being written off over the life of the lease or the life of the buildings or equipment whichever is shorter. This, of course, is the customary treatment of such items. The life of the lease is construed to include both the original term and the renewal period. However, improvements to leased property include a tunnel and two

[14] *Ibid.*, Footnote G.

[15] *Ibid.*, Footnotes B and F.

bridges which were built under a franchise from New York City. This franchise is terminable at any time by the city on sixty days' notice, and such termination would require dismantling of the bridges and tunnel. The improvements are being depreciated at the same rate as the buildings to which they are attached, or, in one instance, over the life of the lease of a building to which the improvement is attached. Such treatment appears to be contrary to the principle that the cost of franchises or of improvements constructed under franchises having an indeterminate life, and cancellable at the will of the granting authority, should be written off as rapidly as possible, rather than over the depreciable life of the asset. The undepreciated balance of these assets on January 31, 1940, was $323,992.85.[16]

Underwood Elliott Fisher Company: Adjustments between Earned and Capital Surplus; Write-off of Intangible Assets

This enterprise, one of the leading manufacturers of business machines, was incorporated on March 8, 1910, in Delaware under the name of the Underwood Typewriter Company. On December 29, 1927, the name was changed to Underwood Elliott Fisher Company. The corporation manufacturers typewriters and flat-surface accounting and writing machines, including the Elliott-Fisher with flat platen, and the Underwood and Sundstrand with cylindrical platen. Other products include Underwood Sundstrand cash registers and adding machines as well as Underwood and Elliott-Fisher fanfold billers. A subsidiary manufactures tally rolls, carbon paper, ribbons, and other supplies for the machines of the parent company. The company's products are marketed primarily through branches in the United States and through dealers in foreign countries.[1]

During the past ten years the surplus accounts of the Underwood Elliott Fisher Company have undergone two complete cycles involving transfers between earned surplus and capital surplus, arising in the first instance out of the virtual elimination of intangible assets from the books of the company. From 1929 to 1933 the Underwood Elliott Fisher Company wrote down its intangible assets, including patents, development expenses, goodwill, etc., to $1.00.[2] This write-down involved an amount of $11,310,309.38, distributed as follows:

1929	$ 2,000,000.00
1930	497,335.00
1933	8,812,974.38
Total	$11,310,309.38

The $2,497,335.00 written off in 1929 and 1930 was charged against earned surplus, but in 1933 the stated value of the common capital stock was reduced from $25.00 per share to $10.00 per share, resulting in the creation of capital surplus to the extent of $9,996,720.00. The $2,497,335.00 previously charged against earned surplus was returned to that account, and the capital surplus of $9,996,720.00 applied to the write-off of intangibles, amounting to $11,310,309.38. However, this left an unabsorbed balance of $1,313,589.38, which was in turn charged against the earned-surplus account.[3] The net result was to increase earned surplus by $1,183,745.62, but this was more than offset by charges of $2,627,314.60 for consolidating facilities,

[16] SEC File 1-280-2, Notes to Consolidated Profit and Loss, January 31, 1940.

[1] SEC Files 1-797-1 and 2-2166-1.

[2] The method used by the company in extinguishing its intangibles is described in this fashion:

"The write-down of intangibles to $1.00 involved writing down to that sum the patents, development and goodwill account of the registrant, the writing off of certain amounts included in its investments in subsidiary companies representing intangible assets, and supplementary adjustments on the books of the subsidiary companies affected to write off their intangible assets in full." SEC File 1-797-1, Item 34 (Revaluations of Property, Plant, Equipment, and Intangible Assets).

[3] SEC File 1-797-1.

depreciation adjustments, etc., and a transfer to a reserve for contingencies of $2,872,685.40. The statement of surplus for the year 1933 reveals the effect of the above steps.[4]

corporated in such products are covered by patents issued from time to time. As the registrant maintains research and patent departments, the perfecting of new features, the filing of patent applications, obtaining the issuance of patents thereon, and the procuring as occasions arise of

Earned Surplus

Balance at beginning of year			$ 9,632,394.41
Net income, including net operating results of wholly-owned subsidiary companies			1,517,942.86
Other additions to surplus:			
Restoration of amounts written off in respect of patents, development and goodwill, against Earned Surplus in 1929 and 1930, now included in amount written off against capital surplus below			2,497,335.00
Total			$13,647,672.27
Charges to surplus:			
Cost of consolidating facilities, adjustments for equalization of depreciation for prior years, for equipment discarded, for revaluation of used machine inventory and sundry minor matters		$2,627,314.60	
Amount transferred to reserve for contingencies		2,872,685.40	
Excess of amount written off in respect of patents, development and goodwill, against capital surplus below, created by reduction in stated value of Common Stock, over amount of such capital surplus		1,313,589.38	
Dividends:			
Cash:			
Preferred—$7.00 per share	$189,350.00		
Common—Year 1933, $.62½ per share; year 1934, $1.62½ per share; year 1935, $2.12½ per share	416,545.28	605,895.28	
Total charges to surplus			7,419,484.66
Balance at end of year			$ 6,228,187.61*
Includes undistributed profits of wholly-owned subsidiaries			$ 1,255,346.12

Capital Surplus

Capital surplus created by reduction of stated value of 666,448 shares of common stock outstanding from $25.00 to $10.00 per share	$ 9,996,720.00
Less patents, development and goodwill—and amounts included in investment in subsidiary companies representing patents, development and goodwill—(including amount previously written off against Earned Surplus, reinstated above) written off, less $1.00	11,310,309.38
Excess of amount written off in respect of patents, development and goodwill, over amount of capital surplus, charged to Earned Surplus above	$ 1,313,589.38

* Balance at end of year includes the Special Surplus Capital Reserve of $2,295,000.00, used, under the requirements of the Certificate of Incorporation, in the purchase and retirement of 22,950 shares of the Preferred Stock, 7% cumulative, and also $303,870.00 aggregate stated value of Common Stock reacquired and held in treasury.

With reference to the writedown of intangible assets, the following statement of the company's policy concerning its patents may be of interest:[5]

The registrant, either directly or through its subsidiaries, owns or controls or has an interest in numerous domestic and foreign patents relating to its various products. These products are the result of engineering work and development over a period of years. Numerous inventions incorporated in such products are covered by patents issued from time to time. As the registrant maintains research and patent departments, the perfecting of new features, the filing of patent applications, obtaining the issuance of patents thereon, and the procuring as occasions arise of licenses under patents of others are carried on by the registrant as a regular part of its business. While many patents, due to elapsed time, have expired, many are still in existence and have various dates of expiration. The registrant makes no representation as to the value, importance or validity of such patents, or patent interests.

No changes, other than additions from net income and deductions for dividends, occurred in surplus during 1934 and 1935, but in 1936 another complicated series of transactions occurred. The company sold

[4] SEC File 2-2166-1, Schedule VII-Surplus.
[5] *Ibid.*, Prospectus p. 2, Item 5.

66,644 shares of common stock at $75.00 per share, a total of $4,998,300.00.[6] Of this amount, $10.00 per share, or $666,440.00 was credited to capital stock, and the remainder, or $4,331,860.00 was credited to paid-in surplus. Then followed the same kind of dual adjustment of surplus that occurred in 1933. The $1,313,589.38 which had been charged against earned surplus in 1933 was now credited back to earned surplus, along with net premiums of $403,928.60 on the acquisition of common and preferred stock, which had been charged to earned surplus at some earlier date. The same $1,313,589.38 was then debited to paid-in surplus, along with $404,545.32 of premiums on common and preferred stock.[7] There is a significant difference between the situation in 1936 and in 1933. In 1933 the capital surplus created

Balance, being earned surplus, January 1, 1936			$ 9,051,043.54
Net income including net operating results of wholly-owned subsidiary companies			3,838,704.04
Other additions to surplus:			
Capital adjustments charged to earned surplus in prior years now restored:			
Premiums on common and preferred stock (net)		$ 403,928.60	
Excess of patents, development and goodwill written off over capital surplus created in 1933		1,313,589.38	
			1,717,517.98
Paid-in Surplus:			$14,607,265.56
Excess of proceeds of 66,644 shares of common stock sold in 1936 over amount ($10.00 per share) allocated to capital stock		$4,331,860.00	
Less:			
Expenses incurred in the sale and issue of additional capital stock	$ 112,938.95		
Premium of $25.00 per share on redemption of 7% cumulative preferred stock	676,250.00		
Premiums on common and preferred capital stock (net) previously charged to earned surplus as above, and on common shares purchased in 1936	404,545.32		
Amount, as above, previously charged to earned surplus in respect of patents, development and goodwill written off	1,313,589.38		
Balance of paid-in surplus appropriated to reserves for investments in and advances to non-consolidated subsidiary companies	1,824,536.35	4,331,860.00	—
Total			$14,607,265.56
Deduction from surplus other than dividends:			
Appropriation to reserves for investments in and advances to non-consolidated subsidiary companies		$ 122,939.53	
Dividends—Cash:			
Preferred—$7.00 per share to September 5, 1936	$ 129,299.00		
Common—$2.87½ per share	2,014,506.07	2,143,805.07	
Total deductions from surplus			2,266,744.70
Balance, being earned surplus, December 31, 1936 as per Balance Sheet			$12,340,520.86

NOTE A: Balance at January 1, 1936, includes undistributed profits of wholly-owned subsidiaries in the amount of $1,639,681.69 and at December 31, 1936, the amount of $1,640,521.19.

NOTE B: Balance at end of year includes $303,950.00 aggregate stated value of common stock, reacquired and held in treasury.

[6] The company estimated the net proceeds of the issue rather accurately. The prospectus contained an estimate that the net proceeds would be $4,879,468.00, whereas actually the expenses were $112,938.95 which, deducted from gross proceeds of $4,998,300.00, resulted in net proceeds of $4,885,361.05, or an excess of $5,893.05 over the original estimate.

[7] The discrepancy of $616.72 between the $403,928.60 credited to earned surplus and the $404,545.32 charged to paid-in surplus presumably represents the premium on a few shares of treasury stock purchased in 1936.

by the reduction in stated value of common stock was not sufficient to absorb the desired charges against it, leaving a residue to be debited against earned surplus. In 1936, on the contrary, paid-in surplus was ample to absorb the charges referred to above, in addition to expenses of $112,938.95 incurred in the sale of stock and a premium of $25.00 per share on the redemption of 7% cumulative preferred stock amounting to $676,250.00.[8] The $1,824,536.35 which remained was appropriated to reserves for investments in and advances in nonconsolidated subsidiary companies. The various changes discussed above are summarized in the statement of surplus for the year 1936.[9]

The treatment of the two items of $403,928.60 and $1,313,589.38, originally debited to earned surplus and now credited back so charged to paid-in surplus, was criticized by the Securities and Exchange Commission. A memorandum, dated August 6, 1938, from the Commission to the New York Stock Exchange voices the following protest:[10]

Earned Surplus:			
Balance, January 1, 1939			$13,886,852.50
Deduct:			
Amounts charged to capital surplus in 1936 in respect of intangibles and capital stock premiums theretofore written off, now charged to earned surplus		$1,717,517.98	
Amount transferred to specific reserve for certain investments to replace reserve previously provided out of capital surplus and now restored thereto		1,824,536.35	3,542,054.33
			$10,344,798.17
Add net income, including equity in net operating results of non-consolidated subsidiary companies (exclusive of those where availability of earnings is seriously curtailed by exchange or other restrictions)			1,857,080.00
			$12,201,878.17
Deduct dividends paid in cash on common stock—$2.00 per share			1,468,600.00
Balance, December 31, 1939			$10,733,279.17
Capital Surplus:			
Balance, January 1, 1939		$ 33,730.56	
Add:			
Amounts transferred from earned surplus		1,717,517.98	
Amounts transferred from reserves in respect of:			
Reserves for investments	$1,824,536.35		
Excess of assets acquired in prior years over cost thereof	236,640.53	2,061,176.88	
Balance, December 31, 1939			3,812,425.42
Total Surplus, as per Balance Sheet			$14,545,703.59

NOTE: Balance of earned surplus at December 31, 1939 includes equity in undistributed profits of non-consolidated subsidiaries in the amount of $1,205,022.19 and $291,790.00 aggregate stated value of common stock, reacquired and held in treasury.

. . . It is noted from Schedule IX that Paid In Surplus, resulting from the excess of the proceeds of common stock sold in 1936 over amount allocated to capital stock, has been charged during the fiscal year under report with $404,545.32 representing "Premiums on Common and Preferred Capital Stock (net) previously charged to earned surplus." It is also noted that Paid-In Surplus has been charged with $1,313,589.38 representing

[8] The chief use to be made of the proceeds of the sale of common stock was to retire $2,705,000.00 of preferred stock at a premium of $25.00 per share, requiring a total of $3,381,250.00. The balance of approximately $1,500,000 was to be used for general corporate purposes.

[9] SEC File 1-797-2, Schedule IX-Surplus (1936 Statements).

[10] SEC File 1-797-2, Form 8, Amendment No. 2 to Statements for 1936.

write-off of patents, development, and goodwill previously (in 1933) charged to earned surplus. Since the foregoing charges were made to earned surplus, which may have been the only surplus account available at the time of such write-off, it does not seem proper to charge these amounts to paid-in surplus created subsequent to such write-off. Unless the certifying accountants can justify, in a letter to the Commission, the propriety of the foregoing charges to Paid-In Surplus it is requested that the balance sheets and Schedule IX be amended to reflect these items in Earned Surplus.

The memorandum was followed by a parenthetical notation, "This matter is under discussion with the Commission." However, compliance with the request of the Commission occurred in 1939, and the earned-surplus account was not only charged with the two items under controversy, amounting to $1,717,517.98, but also the $1,824,536.35 transferred to reserve for investments and originally debited to paid-in surplus.

Capital surplus, on the other hand, which at the end of 1938 had a balance of only $33,730.56, arising out of treasury stock dealings in 1938, was now increased by the $1,717,517.98 and the $1,824,536.35 referred to above, as well as by an item of $236,640.53 representing the excess of assets acquired in prior years over the cost thereof. The resultant balances were $10,733,278.17 in earned surplus and $3,812,425.42 in capital surplus. The statement of surplus for 1939, incorporating these changes, is reproduced on the preceding page.[11]

It will be noted that the correction of the surplus accounts applies only to the adjustments which were made in 1936, and that the comparable adjustments made in 1933 remained uncorrected. The jurisdiction of the Securities and Exchange Commission did not extend back to the earlier period, so the Commission was apparently content with the adjustments referred to above. Nevertheless, if the 1936 entries needed correction, it would seem that the 1933 entries should likewise be adjusted. In neither case does there appear to be adequate justification for the entries in the surplus accounts which actually occurred. Material changes in earned surplus and capital surplus resulted from mere book entries which were not necessarily the result of the transactions from which they allegedly originated, and, no matter how carefully explained, the significance of the various steps taken is almost certain to be either confusing or obscure to the average person reading the published statements.

[11] SEC File 1-797-2, Schedule IX-Surplus (1939 Statements).

THE ACCOUNTING EXCHANGE

Accounting Trivia

I

There are many fields in which useless survivals in custom continue for an almost indefinite period; perhaps the stock illustration is found in the buttons on a man's cuff, which once had a distinctly utilitarian purpose. But while this purpose has long since disappeared, the buttons are still found on the cuff. Bookkeeping is particularly subject to instances of atavistic survival. Some of them have disappeared. Paciolo devoted an entire, though short, chapter to the necessity of including in the journal entry the prepositions *per* and *a*. Much later, bookkeeping texts in England insisted on such a formula as "By Cash Debtor to Notes Payable Creditor." Through successive abbreviation "Debtor" and "Creditor" were dropped, still later "by" was omitted, so that the entry would read, "Cash to Notes Payable," and at the present time the custom is to give only the titles of the ledger accounts. While some of the earlier technical procedures have been dropped, these here mentioned still persist. How much longer will they continue?

II

One such universal custom which even today is occasionally found in textbooks is that of using the broad column in the conventional ledger to record the name of the contra account. Thus, a cash account in the ledger might conceivably show the following:

Dec. 25	Expenses	25
Dec. 27	Notes Payable	1,000
Dec. 30	Purchases	200
Dec. 31	Balance	1,200

In this case it is indicated that a debit of $25 is to be found in an account entitled Expenses, that a debit of $1,000 is to be found in an account entitled Notes Payable, etc.

In recent years the custom of thus recording the contra account has very generally been abandoned except in textbooks. This in part was due to the introduction in the early 17th century of compound journal entries with the consequent meaningless entry, "Sundries," as no single account represented the amount credited. The curious fact is that while the broad column is generally left vacant there still appears as a last item the word "Balance." This word, "Balance," similarly indicated the title of an account in which a contra debit —$1,200 in this case—had been entered. Such an account no longer exists in American ledgers. The curious fact is that the name of actual accounts in which debits have been made are omitted, but there still is retained the name of a non-existent account in which, of course, no debit can be made.

III

Closely connected with this is the entry as the first item in the account for the following period, "Balance, $1,200." Frequently this bears the longer title, "Balance Brought Down." The impression is therefore made that "Balance" as used in ledger accounts means the amount on hand instead of the name of an account in which the contra entry would appear. That this is incorrect is clearly shown by the fact that in early English texts the amount on hand is not called "Balance" but is called "Reste" or "Remayne." The same differentiation is made in other languages, as for instance in Italian, where the amount on hand is called "Saldo," while the name of the account in which the contra entry is made is titled "Bilancio." Furthermore, instead of the amount of

cash on hand in the illustration above, $1,200, being brought down, historically it has made a long, roundabout journey, being debited to the Balance account, probably at the end of the ledger, while the debit in the Cash account for the following period is offset by a credit to a new account, the opening balance.

IV

The conventional form of balancing a ledger account is illustrated below:

Cash

	2,425		1,225
		Balance	1,200
			2,425
Balance	1,200		

Some accountants have boldly stated that this is practically an essential of proper bookkeeping, that the account of the preceding period must show the debit footing equal to the credit footing. Why this idea has persisted it is difficult to understand. Such a method of showing the remainder is not used at all in the so-called Boston ledger, nor is it used in the three-column ledger which provides columns for debits, credits and balances. A much simpler procedure is shown as follows:

Cash

	1,400	25
	1,025	1,000
		200
	2,425	1,225
Balance	1,200	

I can conceive of no reason why this is not satisfactory; it certainly is a labor-saving procedure, and any reasonably competent bookkeeper would have no difficulty in verifying the statement that $1,225+1,200=2,425$.

V

Another curious thing in accounting procedure is the listing in the balance sheet of an item called "Inventory." An inventory is a list, and while it is eminently desirable for the merchant to prepare a priced list of his merchandise it is not the list which is worth $20,000 but the merchandise. Why should not merchandise appear in the balance sheet as merchandise, just as the other items listed among the assets are presumably listed under their proper names, barring such intentional misrepresentation as the listing of discount on capital stock as goodwill?

VI

Not infrequently an item appears among the assets with the title "Cash on Hand." If this is intended to differentiate cash in the till from what is ordinarily called cash in bank, the term used is entirely proper. This is rarely the case, for the item "Cash on Hand" ordinarily includes bank deposits. Why do accountants think it necessary to say that the cash is "on hand" any more than to say the machinery is "on hand" or the office equipment is "on hand"? Even the merchandise is not ordinarily characterized as being "on hand," although some of it may be in the store and other portions in a distant storage warehouse.

VII

When by some sad mishap John Smith is debited $100 which should have been debited to Thomas Green, the recognized method of correcting the error in Smith's account is to credit his account with $100. This entry is ordinarily spoken of as a cross entry. The origin of that term is perhaps little known. It is not so called because it is written across the dividing line of the ledger account. The term originated when it was customary to indicate such a correcting entry by writing a small cross

beside the entry in the margin of the ledger. This gave it the name of a cross entry. There is some likelihood that the cross was used in this case to offset any evil effect of having made a wrong entry. Thus the early devout accountants insisted that, in the words of Paciolo, a new ledger must be commenced with the "glorious sign of the cross, before which every enemy flees and the powers of Evil deservedly tremble."

Henry Rand Hatfield

Why Last-In?

Opponents of the last-in-first-out system usually offer, as their first point of attack on that system, the claim that last-in is an artificial means to stabilize earnings and balance sheet figures. This thought is expressed by Mr. George R. Husband in an article of the last issue of Accounting Review thus: "Effective support (for last-in), if such exists, rests on some supposedly desired resultant in either the balance sheet or the income statement."

Unless one questions why these gentlemen insist upon setting up a straw man at which to shoot, it must be presumed that they have not really investigated last-in. Because, of course, they entirely misrepresent the object of the system. That it does accomplish certain desirable results has been demonstrated time and again. But its aim and purpose is to reflect correctly the operating results of a given business during a given accounting period. The results in question flow from this, but are incidental.

Disregarding for the minute all technical or academic discussion respecting the differences between last-in and first-in, there is one definite and indubitable fact that must be pointed out here. Businesses employing last-in can and should be able, at the close of any given accounting period, to disburse in dividends every penny of earnings shown, no matter whether or not their raw material prices were rising or declining during the period, and yet start the new accounting period with the same real wealth as at the beginning of the then previous period. Users of first-in cannot do this in times of ascending prices. They cannot pay out all, or even any large percentage of their "profits" without depleting cash assets or borrowing money, because of the need of cash for carrying high-priced stocks of goods.

Stripped of all side issues, a "profit" that you can't spend and may never be able to spend is not a profit. It is merely a bookkeeping item.

Before attempting to discuss the arguments that Mr. Husband advances against last-in, let the writer make his position clear. He is not an accountant. His entire career has been devoted to writing for the investor, and his point of view is naturally inclined to that which serves the investor. And the investor is only interested in profits that can be paid him in the form of dividends.

If accounting is to accomplish its true purpose, it must first, last, and all the time, inform the investor. The day is past when accounting was merely a check-up for managements, which knew details not appearing on the accounts. Today the accountant is the guardian of the interested investors in our far-flung businesses. I think it was G. K. Chesterton who said that the fact without the truth is false. The investor depends upon the accountant for the truth, and if the latter fails in his responsibility in this respect, he fails in all.

Mr. Husband suggests that what he calls the fund idea of last-in, to be logical, must be applied to all assets, including property, cash, receivables, etc. As the writer understands him, he admits that a certain amount, or fund of property, cash, and so on, is necessary. But, he asks, why not evaluate all assets on last-in?

The answer is simple.

Property, buildings, etc., are treated today in much the same way as advocates of last-in demand for inventory. Regardless of the fact that property accounting is susceptible of much improvement, a certain similarity between property and inventory is admitted and even emphasized in the last-in theory. They share one important attribute. They both represent "things," whose realizable value in money changes constantly.

Money is merely a medium of exchange for things. It has no other value. And cash items, in which we may include receivables, are purely money items. Their realizable value is not uncertain; they represent the realization. Treat them as a "fund," or however you please, they remain money and must be so stated.

Mr. Husband next questions the application of last-in in respect to style goods and perishables. So far as the writer is aware, no advocate of last-in has suggested its applicability to style goods. In the industry where styles play the most important part, a system of accounting designed for that industry's needs has been devised. It is entirely unlike either last-in or first-in.

It is of course true that perishable goods must be replaced with newer goods. But assuming that they are the same goods in essence (else last-in would not apply) they represent the same wealth. More, they represent the same value to the business in earning power as the goods they replaced.

Next Mr. Husband states that the use of last-in leaves no basis for classifying inventory as a current asset. And so what? Proponents of last-in insist that inventory is in effect a fixed asset because it must be replaced. Its position on the balance sheet is really a minor matter.

The danger that, in periods of declining prices, inventories may be overstated under last-in, and the inventory thus deceived, is another argument advanced by Mr. Husband. Now the very heart and core of last-in, so far as this writer's long experience in analyzing corporate reports is concerned, is that it deceives the investor less than does first-in.

The suggested danger of over-statement is another bogeyman. The last-in theory itself provides, in its application, the means of avoiding this danger. There are several methods of accomplishing this end. The first, of course, is the setting up of a reserve adjusted each year to indicate any difference between stated cost and market. Another is by the use of balance sheet notes. Either of these methods—and I believe the Securities and Exchange Commission would agree—is, from an accounting standpoint purely, acceptable.

Most advocates of last-in, however, while admitting their accuracy, hold that they tend to confuse the average investor. For this reason they recommend the employment of a method that has worked successfully for some forty years. They suggest that inventory be carried at a more or less nominal level, preferably the lowest price at which the items making it up have sold in recent depressions, charging off any difference to the balance sheet surplus—which, except to the accountant, means very little.

Throughout his article, Mr. Husband lays stress on the "historical approach" to accounting. One is almost tempted to employ unparliamentary language in regard to this. Every science and profession that has progressed has done so because it discarded the historical approach. Had medicine and surgery not done this, surgeons would still be operating with dirty fingernails. The sooner accounting forgets history the better for the public, the concerns that employ auditors, and for accountants themselves.

"Accounting," said Mr. Husband, "is not couched in terms of physical quantities; its function is to express relative eco-

nomic success." Both these statements are accurate, but not as he plainly means them. For one of the troubles with accounting lies in just this, that it attempts to ignore physical quantities, things, which refuse to be ignored and impose a penalty for the snub, a penalty that only too often takes the form of bankruptcy for the accountant's clients. And if the function of accounting is, as it undoubtedly is, to express economic success, this expression must take account of things. Again, money is only a medium of exchange for physical things or services, and has no other value.

In his concluding paragraph, Mr. Husband imputes none too worthy motives to the advocates of last-in, a form of argument to which it is impossible to retaliate politely. Of motives, like tastes, "non est disputandum." His final sentence, that last-in fails in the presentation of facts, is certainly disputable. Perhaps it fails from the viewpoint of the "historical" accountant. In so far as protecting and informing the investor, who, in the final analysis, is the employer of most accountants, it comes nearer to accomplishing its purpose than does any other method yet devised.

ARUNDEL COTTER

ACCOUNTING THESES

Theses Accepted for the Ph.D. Degree, Year Ended June, 1940:

Accounting for Depreciable Fixed Assets, Harold G. Avery, *Columbia University.*

Accounting for Distribution Costs, Donald R. Longman, *Columbia University.*

Anti-Chain Store Tax Legislation, Maurice W. Lee, *University of Chicago.*

The Evolution of Elementary Cost Accounting Theories and Technique, S. Paul Garner, *University of Texas.*

The Federal Income Tax Concept of Corporation Income, Charles J. Gas, *University of Illinois.*

The Influence of Costs of Production and Price Policy in a Joint Product Industry, Francis M. Boddy, *University of Minnesota.*

Internal Auditing, Victor Z. Brink, *Columbia University.*

Inventory Valuation and Income Measurement, Carl Devine, *University of Michigan.*

Logical Transaction Analysis, George Bueker McCowen, *University of Illinois.*

Realization of Income and Income Tax Procedure, Russell Bowers, *University of Michigan.*

Ph.D. Theses in Progress as of June, 1940:

Accounting as an Aid to Compliance with the Robinson-Patman Act, William E. Thomas, Jr., *University of Illinois.*

The Accounting Aspects of Proposals for Federal Licensing of Corporations, Robert I. Dickey, *University of Illinois.*

Accounting for Inventories and the Business Cycle, A. R. Burton, *University of Nebraska.*

Accounting for the Managers of Consumers' Cooperatives, Lennare G. Bryngelsson, *Columbia University.*

Accounting Concepts of Income, Shing Yipe Wong, *Columbia University.*

The Accounting Problems Underlying the Adjustment of Merchandise Losses, Leo Rosenblum, *Columbia University.*

Accounting under the Chandler Bankruptcy Act, C. C. Gulley, *University of Texas.*

Some Aspects of the Tennessee Valley Authority Power Program, William F. Butler, *University of Virginia.*

Background of Financial Policy in the Declaration of Dividends, Raymond Einhorn, *University of Illinois.*

Changing Concepts of Depreciation, Edward J. Kirkham, *University of Illinois.*

Comparative Study of Accounting Systems Used by State Governments, F. F. Tannery, *University of Texas.*

A Critical Analysis of Certain Formulations of Accounting Principles, Leslie J. Buchan, *University of Illinois.*

Devaluation and Appreciation of Fixed Corporate Plant from the Standpoint of Accounting, Winfield S. Briggs, *Columbia University.*

The Development of C.P.A. Legislation in the United States, Ralph L. Boyd, *University of Illinois.*

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in Cost Analysis, Lee Glover, *Columbia University.*

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A Study of Operating Profits and of Profits Resulting from Price Changes, Shing Leung Chau, *University of Chicago.*

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Master's Theses Completed, Year Ended June, 1940:

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Accounting for Motion Picture Theater Circuits, Henry Seider, *Columbia University.*

Accounting for Non-Profit-Making Organizations, John Sinsheimer, *Columbia University.*

Accounting for No-Par Value Capital Stock Depreciation, Melvin H. Lichtman, *College of the City of New York.*

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Good Will and Its Treatment in Accounts, Maximilian Bulla, *Columbia University.*

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Last-in, First-Out Method of Valuing Inventories, Esther D. Flashner, *Columbia University.*

Legal and Accounting Aspects of Organization Expenses, V. H. Vincent, *University of Texas.*

Method of Accounting for Mortgage Principal and Income in Savings Banks, Harry L. Mitchell, *Columbia University.*

Objective Tests in Cost Accounting, Edward Shanahan, *Columbia University.*

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Payroll Taxes and Their Accounting Problems, Erle M. Constable, *University of Nebraska.*

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A Proposed Cost Accounting Method for a Sugar Refinery, Cedrie Lee Gillespie, *Boston University.*

The Publisher's Balance Sheet, William MacDaniels, Jr., *Columbia University.*

Realized and Unrealized Income, Maximilian Mintz, *Columbia University.*

Some Reasons for Balance-Sheet Audit Procedures with Respect to Current Assets, Stewart A. Collins, *University of Illinois.*

Reducing the Cyclical Effects of Inventory on Financial Statements, Benjamin B. Blitzman, *College of the City of New York.*

The Responsibility and Liability of the Public Accountant, John McMahon, *Columbia University.*

The Securities and Exchange Commission in Relation to Current Accounting Procedure, Lewis Edward Rossiter, *Washington University.*

Should Research Expenditures Be Capitalized? William A. Corrigan, *University of Pennsylvania.*

Standard Cost Accounting and Some of Its Controversial Phases, Leo McCabe, *Columbia University.*

A Standard System of Accounting for Small Independently Owned Drug Stores, Vinton S. Curry, *University of Colorado.*

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Study of Fixed Asset Disclosures on Published Financial Statements, L. R. Briggs, *University of Texas.*

A Study of the Needs and Facilities for Training in Accounting in Secondary Schools and Business Colleges in North-East Kansas, Fred M. Priestley, *University of Colorado.*

Study of the Presentation of Current Assets on the Balance Sheet as Reflected in Published Statements, Jim Haynes, *University of Texas.*

A Study of the Value of Standard Ratios in Financial Statement Analyses, William B. Williams, *University of Pennsylvania.*

A Study of Various Audit Procedures for the Liability Side of the Balance Sheet, Robert L. Collins, *University of Illinois.*

Surplus Available to Stockholders in New York State, Arthur Kaplan, *College of the City of New York.*

A Survey of Services Rendered by Certified Public Accountants in the South, William C. Boney, *University of Pennsylvania.*

Survey of Special Types of Accounts Receivable Ledgers, Hilma Altmiller, *Columbia University.*

Synchronization Schedules as Measurements of the Debt Paying Ability of Business Firms, Richard R. Cole, *University of Southern California.*

The Tax Treatment of Capital Gains and Capital Losses, Fred E. Roedger, *University of Illinois.*

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Tests and Measurements in Cost Accounting, John Warren, *Columbia University.*

A Uniform System of Accounts for Municipalities in New Mexico, John M. Byrne, *University of Colorado.*

A Uniform System of Accounts for Small Real Estate and Insurance Agencies, William R. Matthies, *University of Colorado.*

Use of Account Books and Records as Evidence in Court, Charles H. Brinkman, *Columbia University.*

Valuation of Intangible Assets, Herman Taylor, *Columbia University.*

What the Investor Expects of the Accountant in Annual Corporate Reports, Kenneth Easton, *Columbia University.*

PROFESSIONAL EXAMINATIONS

A Department for Students of Accounting

HENRY T. CHAMBERLAIN

THE FOLLOWING PROBLEMS are the second half of the May, 1940 C.P.A. examination prepared by the Board of Examiners of the American Institute of Accountants. The examinee was given six hours to solve problems 1, 2, 3 and either problem 4 or 5. The problems were weighted as follows: problem 1, 10 points; problem 2, 25 points; problem 3, 30 points; problems 4 and 5, 35 points each.

No. 1

Corporations A and B are entirely owned and controlled by the same interests. A's condensed balance-sheet of December 31, 1939, is as follows:

Assets

Current assets	$ 500,000
Patents	340,000
Plant	200,000
	$1,040,000

Liabilities

Current liabilities	$ 350,000
Reserve for amortization	40,000
Capital stock	50,000
Capital surplus	450,000
Earned surplus	150,000
	$1,040,000

The company was organized on January 1, 1938, and on that date acquired fully developed patents through the issuance of 34,000 shares of capital stock of no-par value with a stated value of $10 per share. On the same date 16,000 shares were sold for cash at $10 a share. On December 31, 1939, the capital stock was given a par value of $1 per share, and the difference of $9 per share, aggregating $450,000, was transferred to capital surplus.

On December 31, 1939, A entered into an agreement with B whereby A, for a consideration of $1, transferred and assigned to B all of its rights and interests in the patents owned by it, retaining, however, a license to use one of the patents. The directors of A placed a value of $100,000 on this license.

Discuss the points involved and outline the entries that will record the transactions on A's books in accordance with good accounting practice, ignoring the effect of diverging state laws.

No. 2

The S. S. Manufacturing Company completed construction of its plant for the manufacture of lawn mowers on January 1, 1939, and commenced manufacturing January 15, 1939. It was decided to establish standard costs and an expert was engaged for that purpose. On the basis of a test of the first five days' operations, and production of 100 lawn mowers per day, the following standard factory cost for lawn mowers was reported:

STANDARD COST PER LAWN MOWER BASED ON PRODUCTION OF 100 LAWN MOWERS PER DAY

Department:	Total	Materials	Labor	Overhead
Wood and paint	$ 2.50	$ .55	$ .90	$1.05
Machine	13.50	5.45	6.15	1.90
Assembly	2.00		1.50	.50
Inspection	2.00		1.00	1.00
Total per lawn mower	$20.00	$6.00	$9.55	$4.45

The standard-cost expert estimated that, in the case of a double shift on any one day, the rate of overhead would be reduced by 20 per cent on the entire production. He also estimated that night shift wages would be 20 per cent more than regular wages.

At the termination of a thirty-day operating period a production statement was submitted to the head office by the works cost accountant, which statement was compared with the standard factory costs in the following tabulation:

PRODUCTION STATEMENT FOR 30 DAYS OF OPERATION

	Actual cost	*Standard cost* *Rate*	*Amount*
Mowers produced (100 mowers per day for 30 days)...........	3,000	3,000	
Factory costs:			
Wood and paint department:			
Materials..........	$ 1,670	$ .55	$ 1,650
Labor..........	2,775	.90	2,700
Overhead..........	4,000	1.05	3,150
Machine department:			
Materials..........	16,000	5.45	16,350
Labor..........	18,600	6.15	18,450
Overhead..........	6,000	1.90	5,700
Assembly department:			
Labor..........	4.525	1.50	4,500
Overhead..........	1,700	.50	1,500
Inspection department:			
Labor..........	2,900	1.00	3,000
Overhead..........	3,250	1.00	3,000
Total cost..........	$61,420		$60,000

Toward the end of the thirty-day period the president of the company received reports from his principal salesman that a number of lawn mowers of company design were being sold at prices considerably lower than the net sales price. The factory accounts, operations, and inventories were investigated and during the investigation the factory cost accountant confessed that he and the factory foreman had:

1. Increased production on the sixth day to 200 lawn mowers per day by running a night shift, and had maintained this rate of 200-per-day production by day and night shifts for four more days.
2. Sold 500 lawn mowers to dealers at cut prices for cash and appropriated the proceeds.
3. Paid the employees their night-shift wages out of the proceeds from sale of the stolen lawn mowers and made no record of the wages so paid.
4. Failed to record anywhere the night-shift production and also failed to record materials used during the night shifts.

Restate the actual and standard production costs for the thirty-day operating period and show the estimated loss by theft of the 500 lawn mowers.

No. 3

The following audited balance-sheets of the three companies—A, B, and C—had been prepared for consolidation as at December 31, 1939:

	A	B	C
Assets			
Investment in Company B—4,000 shares	$ 480,000		
Investment in Company C—1,500 shares		$ 150,000	
Other assets	3,201,000	965,000	$269,000
	$3,681,000	$1,115,000	$269,000
Liabilities and net worth			
Liabilities	$ 425,000	$ 191,000	$ 36,000
Capital stock			
Number of shares	22,000	6,000	2,000
Par or declared value	$ 100	$ 90	$ 100
Amount	$2,200,000	$ 540,000	$200,000
Capital surplus		$ 60,000	
Earned surplus			
At January 1, 1939	$ 937,000	$ 288,000	$ 38,000
Profit for 1939	559,000	54,000	3,000
	$1,496,000	$ 342,000	$ 41,000
Dividends declared in 1939	440,000	18,000	8,000
At December 31, 1939	$1,056,000	$ 324,000	$ 33,000
	$3,681,000	$1,115,000	$269,000

The investments in Companies B and C were acquired at the close of the year 1938, and the 1939 dividends paid or declared thereon have been credited to income. The capital surplus of Company B arose through the sale of its no-par capital stock at $100 per share, of which $90 was designated as its declared value and the balance of $10 was credited to capital suplus. There are no intercompany accounts or relations other than those that are indicated above.

Prepare:

(a) Columnar work sheet showing the consolidation.
(b) Consolidated balance-sheet.
(c) Statement of minority interest.
(d) Statement of capital surplus.
(e) Statement of consolidated profit for the year.

No. 4

James Roe died on December 31, 1938, and left an estate that was to be divided equally among his four children, all legally of age:

Mary Roe Powell
Albert Roe
Edward Roe
Ethel Roe

All funeral expenses, doctor's bills, and other liabilities, including all death duties and estate taxes were to be paid by the Cohasset Trust Company from a fund that had been provided by the deceased during his life time and was on deposit with the trust company. Any balance remaining in this fund, after all payments had been made, was to be retained by the trust company in payment for their services. The trust company agreed to accept that balance in full settlement.

Two trusts will ultimately be set up—one for Mary and the other for Ethel. The eldest son, Albert, was appointed sole executor and trustee of the estate and of the trusts to be created. The principal of each trust was to remain intact during the beneficiary's life time, but each beneficiary had the right of appointment (by this right each daughter could direct to whom the principal of her trust should be paid at her death. The two sons, Albert and Edward, were each to received their one-

quarter share without any restrictions. The net income from the estate was to be distributed semiannually.

The investory of the estate consisted of:

Cash in bank	$ 100,000
$400,000 3¾% municipal bond at market value	400,000
20,000 shares no-par value stock of Roe Manufacturing Company, appraised at	5,400,000
1,000 shares Cohasset Trust Company stock of $100 par, market value $300 per share	300,000
Waterfront property at Cohasset Bay, appraised at	800,000
	$7,000,000

The heirs decided to leave the estate undivided for the present under the trusteeship of Albert Roe, who with his brother Edward and his brother-in-law John Powell, continued the management of the Roe Manufacturing Company.

The coupons of the municipal bonds were payable on June 30th and December 31st. The Roe Manufacturing Company continued to pay each month a dividend of 50 cents per share and the Cohasset Trust Company paid a dividend of $12.50 per share both on June 1st and December 1st. No income was received from the Cohasset Bay property.

On July 1st, 1939, Ethel Roe was killed in an automobile accident. By the terms of her will, appointing Albert Roe executor, she left $500,000 in specific bequests, the balance of her estate to be equally divided among her brothers and sister. The estate of Ethel Roe consisted solely of her interest in the estate of her father, with the exception of cash in bank which was just enough to pay burial costs, death duties, and all other liabilities.

The executor of the estate of James Roe, with the consent of the court and of the other heirs, decided to advance to the estate of Ethel Roe the $500,000, required to pay the specific bequests and to charge the amount against her share in the estate of James Roe. It was likewise decided to grant the requests of Albert Roe for an advance of $200,000 and of Edward Roe for an advance of $100,000 against their shares in the latter estate. Both agreed to interest charges on these advances from July 1, 1939, at a reasonable rate that would also be fair to the Mary Roe Powell trust, but no interest would be charged on the $500,000 advanced to the estate of Ethel Roe.

In order to provide the necessary cash funds on July 1, 1939, the $400,000 municipal bonds and the 1,000 shares Cohasset Trust Company stock were sold respectively for $420,000 and $320,000 net after brokers commissions, taxes, and other selling expenses, and on that date the above advances were made.

No change in the executorship and trusteeship of Albert Roe was to take place on account of Ethel Roe's death but, with the consent of the court and of the heirs, her remaining interest in her father's estate was to be divided as of the date of her death in accordance with the terms of her will.

The trustee paid the following expenses in 1939:

Incidental expense for the year applicable in equal amounts to the six months before and after the death of Ethel Roe	$ 1,290
Taxes on real estate, payable in June and December	$18,000
Trustee's commissions at the legal rates for "receiving and paying out" as follows:	
5% on the first	2,000
2½% on the next	20,000
1½% on the next	28,000
2% on the balance	
(One half of these rates is for receiving and one half for paying)	
The same rates apply to principal and to income cash.	

(a) Prepare a columnar work sheet to which the transactions in the six months before and after division of the Ethel Roe estate are posted so as to produce the balance-sheets of the estate of James Roe immediately after the division of the estate

of Ethel Roe on July 1, 1939, and on December 31, 1939.

(b) Prepare the trustee's intermediary accounting as at December 31, 1939, in the form of a "charge and discharge" statement, showing the payments to each beneficiary.

(c) Show the calculation of the rate of interest charged to Albert and Edward Roe and give the reason why the use of that rate should be considered fair to the Mary Roe Powell trust. Also mention at least two other ways of dealing reasonably with the interest.

No. 5

The Zenith Junior College had always kept its accounts on a so-called "commercial" basis and not in the form ordinarily used by educational institutions. The balance-sheet of June 30, 1938, and the related statements of income and expenses for the year ended on that date were made up as follows:

BALANCE-SHEET—JUNE 30, 1938

Assets

Current assets		
Cash	$ 6,000	
Tuition fees receivable	8,000	
Inventory of supplies	2,000	$ 16,000
Endowment fund investments		
Rented real estate—at cost	$ 75,000	
Less—Reserve for depreciation	15,000	
	$ 60,000	
Six per cent mortgages—at cost	140,000	
$210,000 five per cent public utility bonds—at cost (market value $202,000)	220,000	420,000
Plant and equipment—at cost		830,000
		$1,266,000

Liabilities

Current liabilities		
Bank loans	$ 15,000	
Accounts payable	9,000	$ 24,000
Five per cent first mortgage bonds maturing at the rate of $15,000 semiannually on June 30th and December 31st of each year		300,000
Endowment fund principal		540,000
Surplus		
Balance at July 1, 1937	$395,000	
Excess of income over expenses for the year ended June 30, 1938, per annexed statement	7,000	402,000
		$1,266,000

STATEMENT OF INCOME AND EXPENSES FOR THE YEAR ENDED JUNE 30, 1938

Income		
Tuition		$230,000
Endowment income		
Rentals	$ 8,100	
Mortgage interest	8,400	
Bond interest	10,500	27,000
Income from auxiliary enterprises		65,000
Unrestricted donations		33,000
Miscellaneous		4,000
Total income		$359,000

Expenses		
Instruction and research	$185,000	
Expenses of auxiliary enterprises	80,000	
Administration	34,000	
Operation and maintenance	35,375	
Depreciation of rented real estate	1,500	
Bond interest	16,125	352,000
Excess of income over expenses		$ 7,000

The above statements were criticized as misleading and the college authorities desire that they be prepared in a form more generally used for educational institutions.

An examination of the books and records brought out the following additional information:

The original college property was completed ten years ago at a cost of $750,000. It was financed by a 5 per cent bond issue of $600,000 and $150,000 appropriated from unrestricted gifts received at the organization of the college. Additions costing $80,000 have since been made from current funds of which $10,000 was spent in the year ended June 30, 1938.

The endowment funds are restricted in respect of principal to their investment in marketable securities and other income-producing properties or to outlays for college buildings and equipment. Income from the investments can be used for any purpose. The endowment-fund assets are less than the endowment-fund principal because investments had been sold from time to time when cash was needed to pay maturing bonds and meet expenses.

Rentals and mortgage interest had been received regularly at the end of every month or quarter and also the June 30, 1938, coupon of the public-utility bonds had been collected on that date, so that no revenues other than the $8,000 tuition fees remained outstanding.

The trustees adopted a policy of charging depreciation on income-producing properties so as to provide a reserve for their ultimate replacement. The amount of this depreciation is to be funded.

The surplus of June 30, 1938, is made up as follows:

Unrestricted gifts at organization	$300,000
Excess of income over expenses	102,000
	$402,000

(a) Set forth in what respects the statements as prepared are unsatisfactory.

(b) Show in the form of properly explained journal entries how the above balance-sheet should be adjusted.

(c) Prepare a balance-sheet in the form that is customary for educational institutions; also a statement of income and expenses.

Solution to Problem 1

The point of this question is the proper treatment of the loss resulting from the sale of the patents. The loss, accepting the value of license rights, is $199,999.00. This loss should be charged against earned surplus and the resulting deficit of $49,999.00 should be shown as such. The earned surplus deficit should not be charged against capital surplus without first getting the formal approval of the stockholders. Under no circumstances should the entire loss be charged to capital surplus.

If the earned surplus deficit is charged to capital surplus (after approval of stockholders) the earned surplus account should be dated to indicate that it runs from a point of time subsequent to the organization of the company.

The entry to record the transaction is as follows:

Cash	$ 1.00	
Patent license	100,000.00	
Reserve for Amortization	40,000.00	
Earned surplus	199,999.00	
Patents		$340,000.00
To record sale of patents		

Solution to Problem 2

It appears that the factory cost accountant has included in his statement of production costs all the actual overhead incurred but has omitted all material and labor costs incurred on the 500 units which were stolen. The additional costs are therefore as follows:

(1) Materials at actual cost as shown by the statement of production:

Wood and paint department, 500 units (1/6 of $1,670.00)	$ 278.33
Machine department, 500 units (1/6 of $16,000.00)	2,666.67
Total	$2,945.00

(2) Labor at 120% of standard cost as per expert's estimate:

Wood and paint department (500 units at $1.08)	$ 540.00
Machine department (500 units at $7.38)	3,690.00
Assembly department (500 units at $1.80)	900.00
Inspection department (500 units at $1.20)	600.00
Total	$5,730.00

Production Statement for 30 Days of Operations

Mowers produced—3500
(100 per day for 25 days, 200 per day for 5 days)

	Actual cost	*Standard cost* Rate	*Standard cost* Amount
Wood and paint department			
Material	$ 1,948.33	$ .55	$ 1,925.00
Labor	3,315.00	.90	3,150.00
Overhead	4,000.00	1.05	3,675.00
Machine department			
Material	18,666.67	5.45	19,075.00
Labor	22,290.00	6.15	21,525.00
Overhead	6,000.00	1.90	6,650.00
Assembly department			
Labor	5,425.00	1.50	5,250.00
Overhead	1,700.00	.50	1,750.00
Inspection department			
Labor	3,500.00	1.00	3,500.00
Overhead	3,250.00	1.00	3,500.00
			$70,000.00
Less 20% of overhead on 1000 units			890.00
			$69,110.00
Additional labor cost due to overtime work on 500 units			955.00
	$70,095.00	$20.00	$70,065.00

The loss of overhead is made up of two factors:

(1) The quantity variance caused by additional production.

(2) The proportionate share of controllable variance (variance resulting from causes other than variances in production).

The quantity variance is computed as follows:

3500 units at \$4.45 per unit	\$15,575.00
Less 20% on 1000 units	890,00
Adjusted standard overhead	\$14,685.00
3000 units at \$4.45	13,350.00
Quantity variance at standard rates	\$ 1,335.00

The total controllable variance is computed as follows:

Actual overhead	14,950.00
Adjusted standard overhead	14,685.00
Controllable variance	\$ 265.00

In terms of overhead the units stolen represent 4/33 of the total output as shown below:

2500 units at normal rates	2,500
1000 units 80% of normal equivalent to	800
	3,300

The units stolen were equivalent to 400 units at normal rates, therefore 4/33 of the controllable variance is charged as an additional loss due to the theft, or \$32.12.

Loss from theft (estimated)

Materials		\$2,945.00
Overhead:		
Quantity variance	\$1,335.00	
Controllable variance	32.12	1,367.12
Total		\$4,312.12

COMMENTS

1. The cost of the material stolen was calculated on the basis of the actual costs incurred for 3,000 units, while the labor cost of the stolen production was based on standard rates. This seeming inconsistency is justified on the ground that the 20% increase in labor cost for night work is based on the standard rate and it was thought best to use the entire standard rate rather than to apply part of the standard rate (the 20% factor) to actual costs incurred for 3,000 units.
2. In computing the quantity variance chargeable to the theft, it was assumed that the S. S. Company would not have operated on an over-time basis; hence the full saving in overhead resulting from over-time operation, \$890.00, is credited against the loss from theft.

Solution to Problem 3

Company A and Subsidiaries Companies B and C
Work Sheet—Consolidated Balance Sheet
December 31, 1939

(a)

Assets	*Company A*	*Company B*	*Company C*	*Adjustments and Eliminations Debit*	*Credit*	*Consolidated Balance Sheet*
Investment in Company B —66⅔%	\$ 480,000.00			(C)\$ 21,500.00	(D)\$613,500.00	\$ 112,000.00 C.S.
Investment in Company C —75%		\$ 150,000.00			(B) 174,750.00 (A) 3,750.00	*28,500.00 C.S.
Other assets	3,201,000.00	965,000.00	269,000.00			4,435,000.00
	\$3,681,000.00	\$1,115,000.00	\$269,000.00			\$4,294,500.00

* Minority interest 33⅓%.

Liabilities						
Liabilities....	$ 425,000.00	$ 191,000.00	$ 36,000.00			$ 652,000.00
Capital stock:						
Company A	2,200,000.00					2,200,000.00
Company B		540,000.00		(D) 360,000.00		180,000.00 M
Company C			200,000.00	(B) 150,000.00		50,000.00 M
Capital surplus		60,000.00		(D) 40,000.00		20,000.00 M
Earned surplus:						
Company A	1,056,000.00				(C) 21,500.00	1,077,500.00 S
Company B		324,000.00		(D) 213,500.00		106,750.00 M
				(A) 3,750.00		
Company C			33,000.00	(B) 24,750.00		8,250.00 M
	$3,681,000.00	$1,115,000.00	$269,000.00	$813,500.00	$813,500.00	$4,294,500.00

Key to Adjustments

(A) To pick up the decrease in the book value of Company C applicable to the investment in that company held by Company B:

Book value of Company C on December 31, 1938	$238,000.00
Book value of Company C on December 31, 1939	233,000.00
Decrease	$ 5,000.00
Applicable to Company B—75% of 5,000.00	$ 3,750.00

(B) To eliminate 75% of the December 31, 1939 book value of Company C.

(C) To pick up the increase in the book value of Company B applicable to the investment in that company held by Company A:

Book value of Company B on December 31, 1939 (per statement)	$924,000.00
Less adjusting entry (A)	3,750.00
Adjusted book value	$920,250.00
Book value of Company B on December 31, 1938	888,000.00
Increase in book value	32,250.00
Applicable to Company A—66⅔% of $32,250.00	$ 21,500.00

(D) To eliminate 66⅔% of the December 31, 1939 adjusted book value of Company B.

(b)

COMPANY A AND SUBSIDIARIES COMPANIES B AND C
CONSOLIDATED BALANCE SHEET
December 31, 1939

Assets			
Sundry assets			$4,435,000.00
Liabilities			
Sundry liabilities			$ 652,000.00
Minority interest:			
Company B:			
Capital stock	$ 180,000.00		
Capital surplus	20,000.00		
Earned surplus	106,750.00		
Capital surplus from consolidation of Companies B and C	9,500.00	$ 316,250.00	
Company C:			
Capital stock	$ 50,000.00		
Earned surplus	8,250.00	58,250.00	374,500.00
Capital stock and earned surplus:			
Capital stock		$2,200,000.00	
Earned surplus:			
Balance, January 1, 1939	$ 937,000.00		
Net income for 1939	580,500.00		
Total	1,517,500.00		
Less dividends	440,000.00	1,077,500.00	3,277,500.00

Capital surplus from consolidation:			
Company C	$ 28,500.00		
Less B minority interest	9,500.00	$ 19,000.00	
Company B		112,000.00	131,000.00
Total			$4,435,000.00

(c)

COMPANY A AND SUBSIDIARIES COMPANIES B AND C
STATEMENT OF MINORITY INTERESTS IN COMPANY B AND C
December 31, 1939

Company B		
Capital stock	$540,000.00	
Capital surplus	60,000.00	
Earned surplus	324,000.00	
Total	$924,000.00	
Less dividends received from Company C in 1939 in excess of the earnings of that company since the date of acquisition by Company B	3,750.00	
	$920,250.00	
Capital surplus arising through the consolidation of Companies B and C	28,500.00	
Total	$948,750.00	
Minority interest—33⅓% of $948,750.00		$316,250.00
Company C		
Capital stock	$200,000.00	
Earned surplus	33,000.00	
Total	$233,000.00	
Minority interest—25% of $233,000.00		58,250.00
Total minority interest		$374,500.00

(d)

COMPANY A AND SUBSIDIARIES COMPANIES B AND C
STATEMENT OF CAPITAL SURPLUS FROM CONSOLIDATION
December 31, 1939

Company B		
Equity in book value of Company B acquired on December 31, 1938 (66⅔% of $888,000.00)	$592,000.00	
Purchase price	480,000.00	
Capital surplus from consolidation applicable to Company A		$112,000.00
Company C		
Equity in book value of Company C acquired on December 31, 1938 (75% of $238,000.00)	$178,000.00	
Purchase price	150,000.00	
Capital surplus from consolidation	$ 28,500.00	
Less B minority interest	9,500.00	
Capital surplus from consolidation applicable to Compzny A		19,000.00
Total capital surplus from consolidation applicable to Company A		$131,000.00

(e)

COMPANY A AND SUBSIDIARY COMPANIES B AND C
STATEMENT OF CONSOLIDATED PROFIT AND LOSS
January 1, 1939 to December 31, 1939

	Company C	*Company B*	*Company A*	*Consolidated*
Net profit, per books	$3,000.00	$54,000.00	$559,000.00	$616,000.00
Less dividends from subsidiaries		6,000.00	12,000.00	18,000.00
Net income of Company A and minority	$3,000.00	$48,000.00	$547,000.00	$598,000.00
Less minority interest	750.00	16,750.00		17,500.00
Consolidated net income	$2,250.00	$31,250.00	$547,000.00	$580,500.00

COMMENTS

1. The minority interest in the profits of Company B is computed as follows:

Net income of Company B, exclusive of dividends received from Company C	$48,000.00
Company B's share of the net income of Company C (75% of $3,000.00)	2,250.00
Together	$50,250.00

The minority of B have an equity of 25% of $50,250.00 or $16,750.00.

2. In this solution the consolidation surplus (capital surplus from consolidation) which arose through the acquisition of Company C stock by Company B, is divided between the Company A interest in Company B and the minority shareholders of Company B. The treatment accorded this item is somewhat unusual but it does seem to be the logical method of dealing with the situation. If the consolidation surplus is the result of a fortunate purchase then the minority stockholders are entitled to their share. On the other hand, if the consolidation surplus is a reflection of overvalued assets on the books of Company C, the write-offs or lessened profits of the future will have to be absorbed by the B minority stockholders and the Company A interest in Company B; therefore, the consolidation surplus should be divided in those same proportions.

Solution to Problem 4

KEY TO ENTRIES

Entries—January 1, 1939 to July 1, 1939

1. To set up the corpus of the estate.
2. To record income for the first six months.
3. To record expenses for the first six months. The trustee's fee is determined as follows:

$ 2,000.00 at 5%	$ 100.00
20,000.00 at 2½%	500.00
28,000.00 at 1½%	420.00
29,250.00 at 2%	585.00
$79,250.00	$1,605.00

4. To close net income to undistributed income accounts.
5. To record distribution of net income.
6. To record sale of investments.
7. To distribute profit on sale of investments.
8. To charge advances to the various legatees.
9. To set up trustee's fees:

Original cash	$100,000.00	
Sale of assets	740,000.00	
2% of	$840,000.00	$16,800.00

10. To charge legatee's for trustees fees:

Ethel	$500,000.00÷98% less $500,000.00=	$10,204.08
Albert	200,000.00÷98% less 500,000.00=	4,081.63
Edward	100,000.00÷98% less 100,000.00=	2,040.82
		$16,326.53

11. To pay trustees fees:

Total fee to be paid when cash on hand is distributed (Entry 9)	$ 16,800.00	
Fees charged on distributions to legatees (Entry 10)	16,326.53	
Balance equal to 2% of cash on hand after deducting fees charged in entry 10 (See below)	$ 473.47	
Total principal cash received		$840,000.00
Payments to legatees	$800,000.00	
Trustees fees to be paid (Entry 10)	16,326.53	816,326.53

Solution to Problem 4 (con't.)

Estate of James Roe, Albert Roe, Executor
Work Sheet

January 1, 1939 to December 31, 1939

	Entries—January 1, 1939 to July 1, 1939: Corpus Debit	Corpus Credit	Income Debit	Income Credit	Balance Sheet July 1, 1939		Income Entries July 1, 1939 to Dec. 31, 1939: Debit	Credit	Balance Sheet December 31, 1939	
Cash in bank	(1) $ 100,000.00	(8) $ 800,000.00	(2) $ 79,250.00	(3) $ 11,250.00	$ 23,434.35	$	(1) $ 60,000.00	(2) $ 10,845.00	$ 23,434.35	
	(6) 740,000.00	(11) 16,565.65		(5) 68,000.00				(4) 49,155.00		
Municipal bonds	(1) 400,000.00	(6) 400,000.00								
Roe Company stock	(1) 5,400,000.00				5,400,000.00				5,400,000.00	
Cohasset Trust Co. Stock	(1) 300,000.00	(6) 300,000.00								
Waterfront property	(1) 800,000.00				800,000.00				800,000.00	
Mary Roe Powell		(1) 1,750,000.00				2,176,598.64				$2,176,598.64
		(7) 10,000.00								
		(12) 416,598.64								
Albert Roe		(1) 1,750,000.00				2,176,598.64				2,176,598.64
		(7) 10,000.00								
		(12) 416,598.64								
Edward Roe		(1) 1,750,000.00				2,176,598.64				2,176,598.64
		(7) 10,000.00								
		(12) 416,598.64								
Ethel Roe	(10) 10,204.08	(1) 1,750,000.00								
	(8) 500,000.00	(7) 10,000.00								
	(12) 1,249,795.92									
Advances: Albert Roe	(10) 4,081.63									
	(8) 200,000.00				204,081.63				204,081.63	
Edward Roe	(10) 2,040.82									
	(8) 100,000.00				102,040.82				102,040.82	
Income and Expense:										
Dividends—Roe			(4) 60,000.00	(2) 60,000.00			(3) 60,000.00	(1) 60,000.00		
Dividends—Cohasset			(4) 12,500.00	(2) 12,500.00						
Bond interest			(4) 6,750.00	(2) 6,750.00						
Incidental expenses			(3) 645.00	(4) 645.00			(2) 645.00	(3) 645.00		
Real estate taxes			(3) 9,000.00	(4) 9,000.00			(2) 9,000.00	(3) 9,000.00		
Trustee's fees			(3) 1,605.00	(4) 1,605.00			(2) 1,200.00	(3) 1,200.00		
Undistributed income:										
Mary Roe Powell			(5) 17,000.00	(4) 17,000.00			(4) 18,936.02	(3) 18,936.02		
Albert Roe			(5) 17,000.00	(4) 17,000.00			(4) 13,833.98	(3) 13,833.98		
Edward Roe			(5) 17,000.00	(4) 17,000.00			(4) 16,385.00	(3) 16,385.00		
Ethel Roe			(5) 17,000.00	(4) 17,000.00						
Deferred charge—trustee's fee	(9) 16,800.00	(10) 16,326.53			473.47				473.47 (see note below)	
Profit on sale of investments	(7) 40,000.00	(6) 40,000.00								
Due to trustee	(11) 16,565.65	(9) 16,800.00				234.35				234.35
	$9,879,488.10	$9,879,488,10	$237,750.00	$237,750.00	$6,530,030.27	$6,530,030.27	$180,000.00	$180,000.00	$6,530,030.27	$6,530,030.27

Note: Trustee's fee for receiving undistributed cash	$239.12
Trustee's fee to be paid when cash on hand is distributed	234.35
Total deferred charge	$473.47

Balance (Before trustees fees for undistributed cash)	$ 23,673.47
Less 2% which will ultimately be paid to trustee	473.47
Cash on hand which will ultimately go to legatees	$ 23,200.00

Balance (Before trustee's fees for undistributed cash)	$ 23,673.47
Cash to be on hand after payment to trustee for undistributed cash received = 23,200.00 ÷ 99%	23,434.35
Trustee's fee for undistributed cash	$ 239.12

Total trustee's fee's

For distributions (See entry 10)	$ 16,326.53
For undistributed cash	239.12
Total	$ 16,565.65

12. To record distributions of Ethel Roe estate.

Entries—July 1, 1939 to December 31, 1939

(1) To record receipt of dividends on Roe Company stock.
(2) To record payment of expenses. The trustee's fee is 2% of $60,000.00 or $1,200.00.
(3) To close income and expense accounts and to credit net income to legatees:

Net income before interest on advances		$49,155.00
Interest at 5% on advances:		
Albert—(.025×204,081.63)	$5,102.04	
Edward—(.025×102,040.82)	2,551.02	7,653.06
Net income		$56,808.06

Distribution

	Mary Roe Powell	*Albert Roe*	*Edward Roe*	*Total*
Net income	$18,936.02	$18,936.02	$18,936.02	$56,808.06
Interest offsets		5,102.04	2,551.02	7,653.06
Net distribution	$18,936.02	$13,833.18	$16,385.00	$49,155.00

(4) To distribute net income.

(b)

ESTATE OF JAMES ROE, DECEASED, ALBERT ROE, EXECUTOR
STATEMENT OF INCOME

January 1, 1939 to December 31, 1939

	January 1 to June 30, 1939	*July 1 to December 31, 1939*	*Total for 1939*
I charge myself with:			
Dividends received:			
Roe Manufacturing Company	$60,000.00	$60,000.00	$120,000.00
Cohasset Trust Company	12,500.00		12,500.00
Interest on bonds	6,750.00		6,750.00
Total income	$79,250.00	$60,000.00	$139,250.00
I credit myself with:			
Incidental expenses	$ 645.00	$ 645.00	$ 1,290.00
Real estate taxes	9,000.00	9,000.00	18,000.00
Trustee's fee	1,605.00	1,200.00	2,805.00
Total expenses paid	$11,250.00	$10,845.00	$ 22,095.00
Net income	$68,000.00	$49,155.00	$117,155.00

Distribution of income:

Mary Roe Powell	$17,000.00	$18,936.02	$ 35,936.02
Albert Roe	17,000.00	13,833.98	30,833.98
Edward Roe	17,000.00	16,385.00	33,385.00
Ethel Roe	17,000.00		17,000.00
Total	$68,000.00	$49,155.00	$117,155.00

Distribution of Income
December 31, 1939

	Income for Division	*Interest Charges Offset*	*Cash Income*
Mary Roe Powell	$18,936.02		$ 18,936.02
Albert Roe	18,936.02	$ 5,102.04	13,833.98
Edward Roe	18,936.02	2,551.02	16,385.00
Total	$56,808.06	$ 7,653.06	$ 49,155.00

ESTATE OF JAMES ROE, DECEASED, ALBERT ROE, EXECUTOR
STATEMENT OF PRINCIPAL

January 1, 1939 to December 31, 1939

I charge myself with:		
Assets per inventory:		
Cash		$ 100,000.00
Municipal bonds		400,000.00
Cohasset Trust Company stock		300,000.00
Roe Manufacturing Company stock		5,400,000.00
Cohasset Bay real estate		800,000.00
Total assets per inventory		$7,000,000.00
Gain on sale of assets:		
Gain on municipal bonds	$ 20,000.00	
Gain on Cohasset Trust Company stock	20,000.00	40,000.00
Total		$7,040,000.00
I credit myself with:		
Bequests paid for the estate of Ethel Roe	$500,000.00	
Advances paid to beneficiaries		
Albert Roe	200,000.00	
Edward Roe	100,000.00	
Trustee's fees on principal	16,565.65	816,565.65
Undistributed balance		$6,223,434.35
Assets on hand		
Cash		$ 23,434.35
Roe Manufacturing Company stock		5,400,000.00
Cohasset Bay real estate		800,000.00
Total assets on hand		$6,223,434.35

(c) The rate of interest charged was 5% because this seemed to be a reasonable rate. Undoubtedly money could be borrowed outside at that rate. This rate seems to be fair since the average rate of return on the securities sold to make the advances was only about 5¼%. Further, the retention of the Roe Manufacturing Company stock was apparently to the advantage of Mary Roe Powell, yet this stock was yielding only about 2.2% on the appraised value.

Other possible methods of dealing with the interest are:

(1) Charge interest at a rate equal to the average rate of return on the securities sold to make the advances.
(2) Charge the advances against the equities of Albert and Edward Roe and distribute the income in the proportions of the remaining equities to the total equity.

COMMENTS

1. Most of the difficulty in this problem has to do with the trustee's fees. It is stated in the problem that the trustee's fees are "at the legal rates for receiving and paying out" and that the rates apply "to principal and income cash." From this it was concluded that fees were based on cash receipts and disbursements only. One wonders where the trustee would come off if he received and distributed an estate consisting entirely of non-cash assets.
2. Trustee's fees applicable to advances made are charged to the legatees receiving the advances and interest is computed on the total of the advances plus fees. This was done because if the advances are returned there will be double fees paid to the trustee. If the advances are not returned no inequity will result if this same practice is followed in future distributions.
3. The calculation of fees due the trustee is based on the assumption that the trustee receives a fee for cash distributed to himself.
4. In calculating the fees to be paid to the trustee the income accounts were charged at the graduated rates on the first $50,000.00 and thereafter all fees were figured on the 2% basis.

Solution to Problem 5

(a)

1. The chief objection to the balance sheet presented is that restricted funds have not been segregated.
2. It is evident that endowment funds have not been held inviolate. This fact should be brought out by segregating the endowment fund from other funds.
3. Since buildings and equipment are not available for current operating purposes and since depreciation has not been provided, these assets and the related bond liability should be set in a separate fund.
4. The general account "surplus" is misleading and should be broken down to show the balances of the separate funds.
5. Changes in fund balances during the year should be shown for each fund.
6. The results of operations, exclusive of income of endowment funds and unrestricted donations dedicated to current purposes, should be shown. Further, capital outlays for retirement of bonds and additions to plant should appear as separate items.

(b)

(1)			
Surplus		$530,000.00	
Building and equipment fund balance			$530,000.00
To segregate in a separate fund the excess of buildings and equipment over first mortgage bonds payable			
(2)			
Due from current fund (Endowment fund)		$120,000.00	
Due to endowment fund (Current fund)			$120,000.00
To set up inter-fund receivables and payables for endowment fund assets used by the current fund:			
Depreciation on rented property	$ 15,000.00		
Various borrowings	105,000.00		
	$120,000.00		
(3)			
Current fund deficit		$128,000.00	
Surplus			$128,000.00
To close the general surplus account and to set up the deficit of the current fund.			

ZENITH JUNIOR COLLEGE

Balance Sheet
June 30, 1938

Assets

Current fund

Cash		$ 6,000.00
Tuition fees receivable		8,000.00
Inventory of supplies		2,000.00
Total		$ 16,000.00

Building and equipment fund

Plant and equipment, at cost		$830,000.00
Total		$830,000.00

Endowment fund

Rented real estate, at cost	$ 75,000.00	
Less reserve for depreciation	15,000.00	$ 60,000.00
6% mortgages, at cost		140,000.00
Public utility bonds, par value $210,000.00, market value $202,000.00, at cost		220,000.00
Due from current fund:		
For depreciation on real estate	$ 15,000.00	
Other loans	105,000.00	120,000.00
Total		$540,000.00

Liabilities

Current fund

Bank loans		$ 15,000.00
Accounts payable		9,000.00
Due to endowment fund:		
For depreciation on real estate	$ 15,000.00	
Other borrowings	105,000.00	120,000.00
Deficit:		
Balance, June 30, 1937	$ 95,000.00	
Net loss from operations	51,500.00	
Capital outlays	40,000.00	
Total	$186,500.00	
Unrestricted donations	$ 33,000.00	
Net income from endowment fund	25,500.00	
	$ 58,500.00	*128,000.00
Total		$ 16,000.00

Building and equipment fund

5% first mortgage bonds, payable $15,000.00 on June 30 and $15,000.00 on December 31 of each year		$300,000.00
Fund balance:		
Balance, June 30, 1937	$490,000.00	
Additions during year	10,000.00	
Bonds retired during year	30,000.00	530,000.00
Total		$830,000.00

Endowment fund

Endowment fund principal		$540,000.00
Total		$540,000.00

* Red.

ZENITH JUNIOR COLLEGE

Statement of Income and Expense and Changes in Current Surplus
July 1, 1937 to June 30, 1938

Income:			
Tuition		$230,000.00	
Income from auxiliary enterprise		65,000.00	
Miscellaneous		4,000.00	$299,000.0
Expenses:			
Instruction and research		$185,000.00	
Expense of auxiliary enterprises		80,000.00	
Administration		34,000.00	
Operation and maintenance		35,375.00	
Bond interest		16,125.00	350,500.00
Net loss on operations			*$ 51,500.00
Add other income:			
Net income of endowment fund used for current purposes:			
Rentals	$ 8,100.00		
Mortgage interest	8,400.00		
Bond interest	10,500.00		
	$27,000.00		
Less depreciation on rented property	1,500.00	$ 25,500.00	
Unrestricted donations used for current purposes		33,000.00	$ 58,500.00
			$ 7,000.00
Less capital outlays			
Bonds retired		$ 30,000.00	
Additions to plant and equipment		10,000.00	40,000.00
Decrease in current fund surplus			*$ 33,000.00

* Red.

COMMENTS

The premium on the public-utility bonds held in the endowment fund should be amortized. It is impossible to make the necessary adjustment because the dates of purchase and maturity are not given.

GENERAL COMMENTS

Though leaving much room for improvement, this section of the examination impressed us as being of better quality than part one, which was reported in the June issue of the REVIEW.

Problem 1 is a good question and a timely one. Problem 2, while not difficult, has its place in the examination.

Problem 3, 30 points, is tremendously overweighted. This problem is so simple that one will question its place in the examination at any weight. If the examiners cannot assume that candidates are equipped for more serious things in the field of consolidations, we teachers had better look into the content of our courses in this subject. The solution takes an unnecessary amount of time, because of the five different parts of the solution.

Problems 4 and 5 raise again the question of optional problems, of which strong disapproval has previously been expressed, the reasons being:

(1) Candidates who solve problems 1, 2, 3 and 4 have not taken the same examination as those who submit solutions to problems 1, 2, 3 and 5. This is true regardless of the weight of the optional problems, but the objection is even stronger when the problems are weighted at 35 points—$17\frac{1}{2}\%$ of the entire examination.

(2) Evidently the examiners have doubts about the place of the problems in the ex-

amination or they would not have made the problems optional.

(3) Most important of all objections is the fact that optional problems waste the examinee's time. He must study *both* problems presented and attempt an analysis of the points in each and then decide in which of the two problems he thinks he will best acquit himself. Obviously, this process is not completed in a few minutes, and valuable time is wasted.

Problem 4 is not a difficult one if the ambiguities regarding the trustee's fees are eliminated. Little knowledge of estates is required for a solution. Problem 5 is a simple institutional set-up requiring the segregation of accounts into fund groups. From the point of view of accounting knowledge required for their solution both problems are overvalued.

A suggested time schedule is given below:

Problem 1	30 minutes
Problem 2	75 minutes
Problem 3	90 minutes
Problem 4	90 minutes
Problem 5	60 minutes

The Accounting Review

THEORIES & PRACTICE

DEFICIENCIES IN FEDERAL ACCOUNTING

For two decades the accounting processes of the Federal government have drifted along without leadership and with no central guiding principle. The papers which appeared in the March issue of the REVIEW amply indicated the dissatisfaction of those who have carefully investigated existing practices. Criticisms have increased in recent years, and Mansfield's THE COMPTROLLER GENERAL, published in 1939, marks the turning point away from the blind acceptance of a complicated, ingrown technique and toward standards similar to those followed in commercial accounting.

There are many persons familiar with Federal accounting to whom the idea of following the commercial pattern is somewhat repugnant. Government, they say, is organized for service, not for profit. But costs are the same everywhere, and government stands to gain if the well-developed notions of cost accountants can be adapted to the Federal picture. The balance sheet of a Federal department, commission, or other agency need not differ from that of a private corporation, except for the net-worth section; yet a number of Federal establishments cannot produce a balance sheet, notwithstanding their ownership and use of various sorts of assets. A statement of operations would have a different appearance; but the essential elements of which it could be composed would be familiar to those accustomed to cost analyses.

From the point of view of the taxpayer as well as that of the political scientist, a language for governmental activities is needed that can be not only generally interpreted but also generally used as a means of communication between citizen-stockholders, legislator-directors, and administration-managements. Accounting is the only language common to these elements in business; why can it not serve government equally well? The answer is that it can; and accountants can help the spread of this idea with but little effort.

A law (Budget and Accounting Act), passed by Congress in 1921, established a General Accounting Office which was supposed to reorganize the accounting procedures of the Federal government and provide an audit service that would supply Congress with financial and operating pictures of the agencies which it had created. As has already been indicated in these columns, the results have not been at all in line with these objectives. Procedures, established by persons without training in accounting, have varied with each department and agency; audits have been made of individual transactions rather than accounts, by "investigators" instead of accountants; and the few financial reports that have been issued can be assimilated neither by members of Congress nor by those trained in commercial practices.

An examination of some of the accounting practices of Federal departments and agencies reveals the existence of confusion that could be easily avoided. To the outsider most of the confusion has a stuffy character; if the horizons of the Federal accounting process could be broadened, the procedures would of necessity take on universal attributes and thus gain in clarity.

1. First on the list of difficulties is the

practice often regarded as fundamental in the accounting for any governmental unit: the booking of budgets and encumbrances. The source of this practice is well known. The Congress (or council, board, or legislature) creates spending programs which are valid over a year or other limited period of time. A budget reflects the limitations of dollars and months. An encumbrance is a contracted expenditure which involves a future delivery of materials or services. Hence an accounting for these limited amounts and periods of expenditure has seemed to warrant expressing on the books of account the details of the budgetary ceiling and the withholding, for disbursement in a future period, of a portion of the current spending allowance.

Where budgets and encumbrances are recorded in the accounts maintained for expenditures a large ledger sheet is generally the result; and on the ledger sheet are the three main classes of items and totals. Bookkeeping machines have been designed expressly for the purpose, and, although expensive, are now common; but the question is often raised by the practical accountant: Is this clumsy method of accounting worth the effort expended in maintaining it? A memorandum budget ledger can be kept even for the largest organization on small cards which will reflect the original allotment or apportionment and any authorized changes upward or downward. Encumbrances and deliveries thereagainst can be maintained by accounts in a file of purchase-order and contract copies; a monthly summarization of the open items is the work of a few minutes. The "budget" status of all the accounts is readily determined at the end of each month by the preparation of a columnar statement in which the three elements of expenditure, encumbrance, and budgetary limit are combined, with unencumbered balances as the final extension. Simple ledger forms would not only make the bookkeeping operation easier but would give to each account a singleness of purpose that would lead to a better understanding by its interpreters—officials, auditors, and the public. Some day it will be discovered that a budget is not an accounting device at all, but a useful, effective instrument of control available to the management of any enterprise, private or public, and that it has no place in the accounts. If the budget items are limited in amount by a legislative appropriation or by a determination of management, various devices are available to those responsible for the administration of the budget to assure them that the predetermined limits are not being exceeded and will not be exceeded. Putting the budget on the books moves a primary responsibility of management into the accounting department—where it does not belong. This point will be amplified at a later date.

2. Most Federal departments and agencies suffer from poorly devised classifications of accounts. Congress in its annual appropriation acts does not distinguish between capital and revenue expenditures; for example, no one knows what portion of the billions of dollars to be spent during the fiscal year 1941 is to be invested in assets whose benefits will extend into future periods and what portion will be currently consumed. No one knows the cost or value of the assets which the Federal government now possesses.

There has been no attempt by the General Accounting Office or any other agency to set forth principles that should be followed in initiating and maintaining an account classification. Not only should accounts serve the management needs of particular establishments, but they should be so constituted that consolidated statements of the Federal Government can be prepared and year-to-year comparisons made. The "balance sheet" prepared by the General Accounting Office is not a

financial statement recognizable by an accountant: current (in part) and other assets (no capital assets are included) are totaled and subtracted from long-term liabilities (current liabilities with minor exceptions are excluded), and the difference (23 billion dollars) is called "national deficit." In view of the fact that many of the long-term liabilities have financed capital assets, the statement is entirely without value for interpretative purposes, and is grossly misleading.

3. In many governmental bureaus and other establishments, confusion arises from the failure to understand and fix the account unit. As in business organizations, financial statements and other account summaries proceed from groupings of individual accounts. These groupings are by objects, organizations, or functions, or by combinations of them, according to the purposes to be served. In governmental accounting, groupings are also made by funds or appropriations. If accounts can be devised for individual activities, and an activity can be defined as being a subdivision of a function, organization, appropriation and fund but never a subdivision of two functions, two organizations, two appropriations, or two funds, difficulties are avoided whenever a compilation of accounts is necessary. But the performance of a service by one organization unit for another, and the distribution of overheads are two examples of overlappings where in order to obtain the cost of an activity in a

FINANCIAL STATEMENT OF THE UNITED STATES, JUNE 30, 1939[a]

ASSETS			
Gold unencumbered			$ 2,358,547,588.83
Silver unencumbered			615,085,905.30
Cash, Treasury offices	$ 34,131,730.08		
Depositaries	1,803,432,187.73	$1,837,563,917.81	
Deduct: Outstanding checks and interest coupons obligations		277,097,755.78	1,560,466,162.03
Accounts receivable			3,196,873.86
Investments[b]			3,788,974,184.55
Loans receivable[c]			738,218,959.03
Cash shortage—public debt[d]			576,243.63
Foreign government obligations receivable[e]			14,026,099,965.65
Total assets			$23,091,165,882.88
LIABILITIES			
Post Office Department			$ 107,748,848.88
5% redemption fund, national bank notes			255,615.16
Exchange stabilization fund			1,804,065,435.31
Special deposit accounts			122,509,851.65
Depositary accounts of governmental corporations and agencies			521,174,510.90
Trust funds, unadvanced			74,488,824.46
Public debt			40,475,241,584.78
Commitments			
To credit of general fund appropriations, unadvanced		$2,378,120,111.91	
To credit of special fund appropriations, unadvanced		202,103,124.86	
To credit of disbursing officers, advances		1,108,976,010.43	3,689,199,247.20
Total liabilities and commitments			$46,794,683,918.34
National deficit			$23,703,518,035.46

[a] Annual report of the Comptroller General of the United States (1939), page 106; supporting comments and schedules have been omitted.
[b] Equities in a few, but not all government corporations.
[c] In part only; a majority consists of interagency fund transfers.
[d] Relates mostly to postmasters' shortages; writeoff authorized by Congress in 1918.
Includes $668,000,000 owing from Germany.

single account, the position of the activity in an organizational or functional structure becomes lost. In some instances clarity may be gained by confining distributions of services and overheads to summary statements and not putting them on the records, so that each account can be said to represent the responsibility of an individual section, bureau, or department head. In any event, every account should possess a maximum amount of intelligibility, even though by itself it may not in all cases express the total cost of an activity. Decisions involving points of this character belong to an administrative field as yet imperfectly explored.

Closely allied with the idea of grouping is the maintenance of controlling accounts. Except for the assets and liabilities of a particular fund or organization, it might be best to avoid controlling accounts altogether on the books of governmental units in order that the activity accounts may be available for any of the valid summaries which can be prepared from them, and in order to give no priority to any one type of summary.

4. Avoidance of controlling accounts does not mean that accounts should not be decentralized. A separate accounting office is justified whenever there is administrative need for it—and the need arises where geographical separation of important operations has occurred, coupled with the right to make independent decisions as to material and personal-service needs. The work of an independent bookkeeping office should be as simple as possible, so that delay may not be experienced in the periodic dispatching of its figures to the home office. The decision required in determining whether branch accounting is to be employed should be recognized as an administrative one; accounts can follow any activity, and still be readily correlated when combined reporting is desired.

Centralization of accounting at a given location usually reduces personnel requirements and speeds reporting and uniformity. The spectacle of separate and unrelated accounting for each elected official, a condition common in municipal, county, and state practice, fortunately is not a problem in the Federal field.

5. Reports prepared from governmental accounts are yet to be developed. The Congress, which appropriates funds a few months in advance of each new fiscal year for the programs of the various spending agencies, receives no financial statements of the results of the spending. It is probably true that the members of Congress know that controls have been instituted to prevent overspending of appropriations which they have made; but there should also be a demand for reports containing analyses of costs of performing the many types of governmental functions and some measure of things accomplished.

Instructors in accounting might well attempt to bridge the gap between the commercial and governmental fields by reducing the number of artificial barriers now separating them. Administrators in the two fields talk different languages, although having common purposes.

Accounting, reflecting, as it does, administrative decisions, can add to its customary functions by defining governmental performance in commercial terms.

PROTECTION FOR INVESTORS

A certain bill, H. R. 10065, was introduced into the House of Representatives on August 1, 1940, by Representatives Cole of Maryland and Wolverton of New Jersey for the House Committee on Interstate and Foreign Commerce. The bill, after five weeks of conferences, had been approved unanimously not only by the House Committee, and the Committee on Banking and Currency of the Senate, but also by the Securities & Exchange Commission, representatives of

the investment companies and investment advisers, who had participated in the hearings and the drafting of the measure. Divided into two titles known as the Investment Company Act and Investment Advisers Act, the bill was the culmination of an extensive study made by the SEC over a period of 5 years, pursuant to section 30 of the Public Utility Holding Company Act of 1935.[1]

The investment companies to be regulated by this measure possess assets having a book value of over $4,000,000,000 (in 1929 the figure was $7,000,000,000), with approximately 2,000,000 investors, 95% of whom own 100 shares or less with a maximum value of $500. The SEC has estimated that the companies have an influence or controlling interest in noninvestment sessing assets of approximately companies 30 billion.

According to Representative Cole, this bill was "designed to provide investors in all investment companies with adequate information with respect to the operation of their company, [and] will prohibit persons convicted or enjoined in connection with security frauds from being associated with these organizations; will insure the presence of independent members of boards of directors; will prohibit the unloading of securities by controlling persons and other insiders on their investment companies; will prevent the future pyramiding of one investment company upon another; will markedly simplify capital structures of investment companies and afford some measure of protection for senior security holders in these organizations; will tend to establish fair pricing and selling methods of investment company securities; will prohibit the issuance of stock for services and eliminate tricky management voting stocks; and will provide a more reasonable sales load on installment plans and insure these investors a more equitable interest in the fund."[2]

Title I, Findings and Declaration of Policy, declares that investment trusts are of national interest, and, as such, attempts to regulate them under Congress' power to regulate interstate commerce.

Section 1(b) states (p. 3):

Upon the basis of facts disclosed by the record and reports of the Securities and Exchange Commission made pursuant to section 30 of the Public Utility Holding Company Act of 1935, and facts otherwise disclosed and ascertained, it is hereby declared that the national public interest and the interest of investors are adversely affected—

(1) when investors purchase, pay for, exchange, receive dividends upon, vote, refrain from voting, sell, or surrender securities issued by investment companies without adequate, accurate, and explicit information, fairly presented, concerning the character of such securities and the circumstances, policies, and financial responsibility of such companies and their management;

(2) when investment companies are organized, operated, managed, or their portfolio securities are selected, in the interest of directors, officers, investment advisers, depositors, or other affiliated persons thereof, in the interest of underwriters, brokers, or dealers, in the interest of special classes of their security holders, or in the interest of other investment companies or persons engaged in other lines of business, rather than in the interest of all classes of such companies' security holders;

(3) when investment companies issue securities containing inequitable or discriminatory provisions, or fail to protect the preferences and privileges of the holders of their outstanding securities;

(4) when the control of investment companies is unduly concentrated through pyramiding or inequitable methods of control, or is inequitably distributed, or when investment companies are managed by irresponsible persons;

(5) when investment companies, in keeping their accounts, in maintaining reserves, and in computing their earnings and the asset value of their outstanding securities, employ unsound or misleading methods, or are not subjected to adequate independent scrutiny;

(6) when investment companies are reorganized, become inactive, or change the character of their business, or when the control or management thereof is transferred without the consent of the security holders;

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[1] Section 30 authorizes and directs the Commission to study "the functions and activities of investment trusts and investment companies, the corporate structures and investment policies of such trusts and companies, the influence exerted by such trusts and companies upon companies in which they are interested, and the influence exerted by interests affiliated with the management of such trusts upon their investment policies, and to report the results of its studies and its recommendations to the Congress on or before January 4, 1937." The Commission's study covered in detail the functions and activities of these organizations.

[2] Congressional Record—76th Congress, 3d session, Vol. 186, No. 140, August 1, 1940, p. 14917.

(7) when investment companies by excessive borrowing and the issuance of excessive amounts of senior securities increase unduly the speculative character of their junior securities; or

(8) when investment companies operate without adequate assets or reserves.

It is hereby declared that the policy and purposes of this title, in accordance with which the provisions of this title shall be interpreted, are to mitigate, and, so far as is feasible, to eliminate the conditions enumerated in this section which adversely affect the national public interest and the interest of investors.

Registered investment companies are required to file with the SEC a statement of policy with respect to: (1) the class of investment company within which they intend to operate; (2) borrowing money; (3) issuance of senior securities; (4) underwriting; (5) concentrating investments in particular industries or groups of industries; (6) purchase and sale of real estate and commodities; (7) making loans to other persons; (8) and other matters which the registrant believes fundamental "and elects to treat as such." In addition, the names, addresses, and intercompany affiliations of all officers must be filed, as well as a statement of their previous business experience. At least 40% of the board of directors must be independent—that is, no more than 60% may be investment advisers to the company or affiliated persons, or officers or employees of the company. A majority must be composed of persons who are not regular brokers or underwriters for the company, or investment bankers, or affiliated persons. Officers, directors, advisers, etc. cannot sell or purchase securities from the company.

Title II provides for the registration of investment advisers—"persons who, for compensation, advise individuals as to investment in securities . . . The title seeks to protect the public from frauds and misrepresentations . . . and to safeguard the honest investment adviser. . . . [The bill] makes fraudulent practices by investment advisers unlawful and requires investment advisers doing business by the use of the mails and the facilities of interstate commerce to register with the Commission which is empowered to deny registration to individuals convicted or enjoined by the courts for securities frauds."[3]

No investment company can make a public offering of its securities unless it possesses at least $100,000 through private subscription, and though no limit is placed on the maximum size of investment companies, the Commission is directed to study the question of size and report on it from time to time. No investment company or group of controlled companies may purchase securities of another investment company which will enable it to own more than 3% of the other companies voting stock. "Investment companies, however, may increase their holdings in other investment companies of which they already hold 25% of the voting stock, since such holdings constitute presumptive control . . . Cross and circular ownership . . . are prohibited in the future and existing cross and circular ownership must be eliminated within five years."[4]

Participation in joint trading accounts, margin trading, and short sales of portfolio securities is not permitted except within limits to be prescribed by the SEC; and "upstream" loans, except by wholly owned subsidiaries, are forbidden.

Closed-end companies can issue only 3 types of securities: one class of indebtedness, one class of preferred stock, and one class of common. Securities covering indebtedness must, at the time of issuance, have an asset coverage of at least 300%, and preferred stock, 200%. Open-end companies cannot issue senior securities but can borrow at banks, if an asset coverage of 300% is maintained at all times. Dividends may not be declared if these coverages are not maintained, and written statements must accompany dividend payments disclosing the source of the payment

[3] *Op. cit.* p. 14918.
[4] *Ibid.* p. 14919.

other than from income or earned surplus.

Upon petition of 25% of any class of security holders, the Commission may give an advisory opinion on reorganizations, and the company must send this opinion to all its security holders. The Commission may institute injunction proceedings to prevent "grossly unfair" reorganization plans from being carried through.

The use and need of accounting as a tool of social control is exemplified in the elaborate accounting requirements provided in the bill; various resources that accounting makes available for control purposes are utilized: minimum accounting and auditing requirements are provided for, which will enable management as well as the Commission to maintain control; reporting requirements to the public and the stockholder are set in the hope that this information will enable them to keep closer watch on the operations of the business and the industry; and the control that adequate disclosure to the public, and to a Commission empowered to act, imposes on management is brought into play. Finally, an attempt is made to force the auditor to recognize his responsibilities to groups other than those who pay his fee: "the selection of independent public accountants of investment companies must be submitted for ratification or rejection to stockholders who, in addition, at any time by a majority vote may terminate their employment. The auditors' certificate must be addressed to security holders as well as the directors. The controller or other principal accounting officer of every company is to be chosen either by the board of directors of the company or by its security holders, and not merely be appointed by its executive officers. The Commission is also empowered to require accountants and auditors to keep reports and work sheets and other documents relating to investment companies."[5] Thus accounting serves all the interested groups: the public, the stockholders, management, the Commission, and the accountant.

[5] *Op. cit.*, p. 14920.

Investment companies are required to file with the SEC annual reports similar to those required under the Securities Exchange Act of 1934, as well as less comprehensive reports on a semiannual or quarterly basis. Reports to stockholders must be filed, and the Commission may require specific information to be sent to the stockholders. To prevent circulation of inaccurate information, as is possible under other acts administered by the SEC, reports to stockholders must not be misleading in the light of information filed with the Commission. The Commission may require certification of all reports based on a reasonably comprehensive audit by independent public accountants. The companies, their subsidiaries, advisers, depositors and underwriters may be required to preserve recordsof transactions—these records to be subject at all times to examination by the Commission. In addition, "the Commission is authorized to provide for a reasonable degrees of uniformity in the accounting policies and principles to be followed by investment companies in maintaining their accounts and records and preparing the financial statements required. . . ."[6]

The following excerpts from the Act are of particular interest to accountants:

Sec. 30 (a) Every registered investment company shall file annually with the Commission such information, documents, and reports as investment companies having securities registered on a national securities exchange are required to file annually pursuant to section 13 (a) of the Securities Exchange Act of 1934 and the rules and regulations issued thereunder.

(b) Every registered investment company shall file with the Commission—

(1) such information and documents (other than financial statements) as the Commission may require, on a semi-annual or quarterly basis, to keep reasonably current the information and documents contained in the registration statement of such company filed under this title; and

[6] *Op. cit.*, p. 14920.

(2) copies of every periodic or interim report or similar communication containing financial statements and transmitted to any class of such company's security holders, such copies to be filed not later than ten days after such transmission.

Any information or documents contained in a report or other communication to security holders filed pursuant to paragraph (2) may be incorporated by reference in any report subsequently or concurrently filed pursuant to paragraph (1).

(c) The Commission shall issue rules and regulations permitting the filing with the Commission, and with any national securities exchange concerned, of copies of periodic reports, or of extracts therefrom, filed by any registered investment company pursuant to subsections (a) and (b), in lieu of any reports and documents required of such company under section 13 or 15 (d) of the Securities Exchange Act of 1934.

(d) Every registered investment company shall transmit to its stockholders at least semi-annually, reports containing such of the following information and financial statements or their equivalent, as of a reasonably current date, as the Commission may prescribe by rules and regulations for the protection of investors, which reports shall not be misleading in any material respect in the light of the reports required to be filed pursuant to subsections (a) and (b):

(1) a balance sheet accompanied by a statement of the aggregate value of investments on the date of such balance sheet;

(2) a list showing the amounts and values of securities owned on the date of such balance sheet;

(3) a statement of income, for the period covered by the report, which shall be itemized at least with respect to each category of income and expense representing more than 5 per centum of total income or expense;

(4) a statement of surplus, which shall be itemized at least with respect to each charge or credit to the surplus account which represents more than 5 per centum of the total charges or credits during the period covered by the report;

(5) a statement of the aggregate remuneration paid by the company during the period covered by the report (A) to al ldirectors and to all members of any advisory board for regular compensation; (B) to each director and to each member of an advisory board for special compensation; (C) to all officers; and (D) to each person of whom any officer or director of the company is an affiliated person; and

(6) a statement of the aggregate dollar amounts of purchases and sales of investment securities, other than Government securities, made during the period covered by the report:

Provided, That if in the judgment of the Commission any item required under this subsection is in applicable or inappropriate to any specified type or types of investment company, the Commission may by rules and regulations permit in lieu thereof the inclusion of such item of a comparable character as it may deem applicable or appropriate to such type or types of investment company.

(e) Financial statements contained in annual reports required pursuant to subsections (a) and (d), if required by the rules and regulations of the Commission, shall be accompanied by a certificate of independent public accountants. The certificate of such independent public accountants shall be based upon an audit not less in scope or procedures followed than that which independent public accountants would ordinarily make for the purpose of presenting comprehensive and dependable financial statements, and shall contain such information as the Commission may prescribe, by rules and regulations in the public interest or for the protection of investors, as to the nature and scope of the audit and the findings and opinion of the accountants. Each such report shall state that such independent public accountants have verified securities owned, either by actual examination, or by receipt of a certificate from the custodian, as the Commission may prescribe by rules and regulations.

(f) Every person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of outstanding securities (other than short-term paper) of which a registered closed-end company is the issuer or who is an officer, director, member of an advisory board, investment adviser, or affiliated person of an investment adviser of such a company shall in respect of his transactions in any securities of such company (other than short-term paper) be subject to the same duties and liabilities as those imposed by section 16 of the Securities Exchange Act of 1934 upon certain beneficial owners, directors, and officers in respect of their transactions in certain equity securities.

Sec. 31 (a) Every registered investment company, and every underwriter, broker, dealer, or investment adviser which is a majority-owned subsidiary of such a company, shall maintain and preserve for such period or periods as the Commission may prescribe by rules and regulations, such accounts, books, and other documents as constitute the record forming the basis for financial statements required to be filed pursuant to section 30 of this title, and of the auditor's certificates relating thereto. Every investment adviser not a majority-owned subsidiary of, and every depositor of any registered investment company, and every principal underwriter for any registered investment company other than a closed-end company, shall maintain and preserve for such period or periods as the Commission shall prescribe by rules and regulations, such accounts, books, and other documents as are necessary or appropriate to record such person's transactions with such registered company.

(b) All accounts, books, and other records, required to be maintained and preserved by any person pursuant to subsection (a), shall be subject at any time and from time to time to such reasonable periodic, special, and other examinations by the Commission, or any member or representative thereof, as the Commission may prescribe. Any such person shall furnish to the Commission, within such reasonable time as the Commission may prescribe, copies of or extracts from such records which may be prepared without undue effort, expense, or delay, as the Commission may by order require.

(c) The Commission may, in the public interest or for the protection of investors, issue rules and regulations providing for a reasonable degree of uniformity in the accounting policies and principles to be followed by registered investment companies in maintaining their accounting records and in preparing financial statements required pursuant to this title.

(d) The Commission, upon application made by any registered investment company, may by order exempt a specific transaction or transactions from the provisions of any rule or regulation made pursuant to subsection (c), if the Commission finds that such rule or regulation should not reasonably be applied to such transaction.

Sec. 32. (a) After one year from the effective date of this title, it shall be unlawful for any registered management company or registered face-amount certificate company to file with the Commission any financial statement signed or certified by an independent public accountant, unless—

(1) such accountant shall have been selected at a meeting held within thirty days before or after the beginning of the fiscal year or before the annual meeting of stockholders in that year by a majority of those members of the board of directors who are not investment advisers of, or affiliated persons of an investment adviser of, or officers or employees of, such registered company;

(2) such selection shall have been submitted for ratification or rejection at the next succeeding annual meeting of stockholders if such meeting be held, except that any vacancy occurring between annual meetings, due to the death or resignation of the accountant, may be filled by the board of directors;

(3) the employment of such accountant shall have been conditioned upon the right of the company by vote of a majority of the outstanding voting securities at any meeting called for the purpose to terminate such employment forthwith without any penalty; and

(4) such certificate or report of such accountant shall be addressed both to the board of directors of such registered company and to the security holders thereof.

Provided, That if the selection of an accountant has been rejected pursuant to paragraph (2) or his employment terminated pursuant to paragraph (3) the vacancy so occurring may be filled by a vote of a majority of the outstanding voting securities, either at the meeting at which the rejection or termination occurred or if not so filled then at a subsequent meeting which shall be called for the purpose. In the case of a common-law trust of the character described in section 16 (b) no ratification of the employment of such accountant shall be required but such employment may be terminated and such accountant removed by action of the holders of record of a majority of the outstanding shares of beneficial interest in such trust in the same manner as is provided in said section 16 (b) in respect of the removal of a trustee, and all the provisions therein contained as to the calling of a meeting shall be applicable. In the event of such termination and removal the vacancy so occurring may be filled by action of the holders of record of a majority of the shares of beneficial interest either at the meeting, if any, at which such termination and removal occurs, or by instruments in writing filed with the custodian, or if not so filled within a reasonable time then at a subsequent meeting which shall be called by the trustees for the purpose. The provisions of paragraph (40) of section 2 (a) as to a majority shall be applicable to the vote cast at any meeting of the shareholders of such a trust held pursuant to this subsection.

(b) No registered management company or registered face-amount certificate company shall file with the Commission any financial statement in the preparation of which the controller or other principal accounting officer or employee of such company participated, unless such controller, officer or employee was selected, either by vote of the holders of such company's voting securities at the last annual meeting of such security holders, or by the board of directors of such company.

(c) The Commission is authorized by rules and regulations or order in the public interest or for the protection of investors, to require accountants and auditors to keep reports, work sheets, and other documents and papers relating to registered investment companies for such period or periods as the Commission may prescribe, and to make the same available for inspection by the Commission or any member or representative thereof. . . .

Sec. 34 (a) It shall be unlawful for any person, except as permitted by rule, regulation, or order of the Commission, willfully to destroy, mutilate, or alter any account, book, or other document the preservation of which has been required pursuant to section 31 (a) or 32 (c).

(b) It shall be unlawful for any person to make any untrue statement of a material fact in any registration statement, application, report, account, record, or other document filed or transmitted pursuant to this title or the keeping of which is required pursuant to section 31 (a). It shall be

> unlawful for any person so filing, transmitting, or keeping any such document to omit to state therein any fact necessary in order to prevent the statements made therein, in the light of the circumstances under which they were made, from being materially misleading. For the purposes of this subsection, any part of any such document which is signed or certified by an accountant or auditor in his capacity as such shall be deemed to be made, filed, transmitted, or kept by such accountant or auditor, as well as by the person filing, transmitting, or keeping the complete document.

The Act is a unique one in many respects. It should be studied carefully by every accountant whether or not he is interested in investment enterprises, for it may set the pattern for future legislation affecting the profession.

E. L. KOHLER

BOOK REVIEWS

Corporate Financial Policy. Harry G. Guthmann and Herbert E. Dougall. (New York: Prentice-Hall, Inc., 1940. Pp. xxxii, 795. $4.00.)

This substantial volume represents a valuable addition to the literature in the field of corporation finance. It is aimed more directly at the solution of problems of financial policy than many of the other textbooks dealing with the subject and includes a wealth of material on current practice, well correlated with underlying principles. The authors believe that only by understanding the reasons that lie behind practice can management chart a proper course of action under varying conditions of business. They are to be congratulated on the results of their efforts to provide a synthesis of these principles with pertinent points of accounting, law, economics, and public policy.

An exceptional amount of statistical matrial and, specific examples are given in support of methods and policy. The reviewer found over 1,100 actual examples but the data is arranged in such a way as to keep it below the burdensome level. The treatise is supplied with footnotes in abundance for purposes of both supplementary context and documentation. An extensive list of references to the best literature on the subject adds materially to the value of the volume. The whole work is characterized by painstaking research which gives it the unique quality of originality.

After discussing the place of corporation finance in the field of business, the authors do not follow the normal life history of the corporation through promotion, operation, expansion, and reorganization. They take up, first, the nature of the business corporation and its advantages and disadvantages as a form of organization in comparison with alternative forms such as the joint-stock company, Massachusetts trust, and the different partnerships. There follows a good exposition of the devices and methods by which the corporation is organized, managed, and controlled. Bonds and stocks, the instruments by which the corporation raises most of its funds, then come in for detailed description followed by a chapter which deals with the general principles of their use. After this prelude, there is a very good discussion of the leading financial questions and problems which arise during the ordinary life of the corporation.

The factors determining the form of capital structure and the various devices by which funds are raised are considered, first, with respect to the newly promoted enterprise and then with the established business. The latter receives exceptionally good treatment under the separate headings of industrials, utilities, and railroads. Later, attention is given to the sale of securities to outsiders through the investment banker and to persons already interested in the business such as stockholders, employees, and customers. It is unusual but commendable to find at this point separate chapters devoted to investment banking and the organized security exchanges.

With the company on an operating basis the discussion is directed toward problems of short-term financing. The sources of current funds to supplement the more permanent contributions of bondholders and stockholders are carefully canvassed and analyzed. Because the business corporation is promoted and operated primarily for profit, a great deal of attention is given to the management of income. The authors display an excellent grasp of the accounting ramifications of corporate financial policy. They consider in detail three alternatives in the handling of net income: It may be used to expand operations, reduce outstanding securities, or distributed in the form of dividends to the security holders. They are careful to mention several frames of reference to provide criterions of managerial activity, such as legality, accepted accounting practice, expediency, and fairness.

The authors are cognizant of the increased interest on the part of the public in the large corporation and the corporate combinations which have emerged as a result of the use of formal and informal methods. Following a general discussion of corporate expansion and combination they analyze in detail the use of various techniques such as informal cooperation, lease, merger, consolidation, holding company, etc., and the effects of the various methods on the different groups involved.

An important section of the book is devoted to the subjects of failure and reorganization. The treatment ranges from simple adjustments accomplished voluntarily to drastic corporate reorganization. The place of the courts and recent legislation are given prominence in the discussion as well as the effect of readjustment on management and security holders. At the present time with crystallization of the post-depression methods taking place, the book represents the most up-to-date treatment of this important phase of corporation finance.

The concluding chapter, devoted to a discussion of some of the more important social and economic problems that arise in connection with corporate financial policy, is of special value, because of increased interest on the part of the public in the social aspects.

On the whole, the chapters are well organized and logically arranged with a good sense of balance and proportion. The material is clearly presented in simple, direct, and readable style. Guthmann and Dougall like to place more emphasis on principles rather than to be merely informative or descriptive. The fact that both writers have been engaged in teaching for many years probably accounts for the fact that they are able to anticipate the sort of questions students and business men are likely to raise and have made their treatment comprehensive enough to supply many answers which are not contained in the ordinary treatise. The reviewer has taught the subject for several years with various texts and has found developed in this volume many aspects of the subject that are merely mentioned or passed over in other textbooks of this type.

L. Thomas Flatley

Mundelein College

Business Cycles and Forecasting. Revised Edition. Elmer C. Bratt. (Chicago: Business Publications, Inc., 1940. Pp. xvi, 814. $4.00.)

It is to be hoped that the formidable appearance of this volume will not deter those interested in business fluctuations from giving this work the attention it deserves.

The aim of the author is to explain the nature of economic change, why it takes place, how it can be measured, and the extent to which it can be forecast. The first 178 pages provide an introduction to the main subject by discussing seasonal variations, economic balance, industrial growth and decadence, and a brief account of statistical methods. The reader who is well grounded in elementary economics and statistics will find it unnecessary to do more than glance at this section. Following this background material the main problem of the book is introduced—the factors responsible for the cyclical nature of business. The author says "In broad outlines the business cycle can be explained by the originating causes and the self-generating movement. The originating causes introduce new forces, and these forces acting in a business system, where responses react upon one another almost endlessly, explain the characteristic upswings and downswings which occur." These upswings and downswings are "recurrent but not periodic." The extent of these swings in activity is ill-defined but is limited by recurrent overproduction and underproduction which " . . . establish unbalance which is an outstanding characteristic of the extremes of the business cycle. In fact the existence of unbalance is the reason for expecting these extremes to be temporary."

In the revised edition a much more adequate consideration is given to business cycle theories. The 1937 edition devoted a short chapter of 13 pages to this subject. In the 1940 edition, cycle theories account for three chapters covering 108 pages. In addition to setting forth the leading theories which attempt to explain the cycle, the author presents a scholarly evaluation of opposing views.

The chapters on business cycle history describe the principal business fluctuations concluding with the depression which began in September, 1937. Special attention is given to the depression which began in 1929 because "It is one of the major depressions of history. The record is better than for any other major depression. This depression is close at hand, and therefore it is reasonable to assume that it better typifies what can be expected in the future than does any one of the earlier major depressions." Much useful material of a reference nature is found in the history chapters.

Various attempts in recent years to control business activity lend added interest to the chapters on schemes for artificial control of cyclical movements. The author logically relates this subject to cycle theories on the one hand, and to the subject of forecasting on the other. It is obvious that the success of control schemes depends upon the ability to forecast with reasonable accuracy.

The volume concludes with a description of the principal business barometers and the problems of forecasting. These chapters give a detailed description of the leading business indexes and point out the advantages and disadvantages of each as aids in forecasting economic change. On the subject of the adequacy of forecasts the author says "We can be fairly sure that the most adequate business cycle forecasts will be for a relatively short period into the future."

Business Cycles and Forecasting is a well-rounded treatment touching upon all phases of the subject with the exception of the social aspects of business fluctuations. The chapters include useful lists of selected references, and the volume is provided with an index and numerous charts and tables.

EDWARD T. BULLOCK

New York University

Principles of Business Law, Second Revised Edition. Essel R. Dillavou and Charles G. Howard. (New York: Prentice-Hall, Inc., 1940, Pp. xxxv, 990. $4.00).

Dillavou and Howard are this year offering a very interesting new edition of their book, *Principles of Business Law*, and this book has many valuable and interesting features. It is a painstaking study of the subject of Business Law, and to teachers who agree with Professors Dillavou and Howard in presenting the subject by principles and cases it will be found to be an excellent work.

There are three theories of approach to writing books on business law: The earliest is the method of writing elementary law textbooks, or in other words, to express in very brief and simple language the fundamental rules of contracts, torts, property, criminal law, and all other divisions and departments of legal science. This method is now generally discarded. The second method is to write more extensively and to use a collection of cases which demonstrate certain contractual principles and principles of negotiable instrument law, real estate law, laws of organization, and the doctrines of agency and sales, on the theory that these particular legal principles have a special application in business practices and conduct. The third is the functional approach, or the examination of business principles and practices and a discussion of the functions which law has in it. It is very common in discussions of this subject to refer to the second as being the orthodox method of teaching and the third as the functional. In as much as they are the three methods of approach, it is well to identify this work at once, and I am sure that to place this work in the second category would be in accord with the author's ideas and beliefs on the subject. The work, by statement of principles and comparison of cases, is a clear demonstration of this method of attack on the problem.

The book opens with a very good, although brief, statement of the nature and classification of law, and the classification of courts and of court procedure. Then follows a very general treatment of the subject of types of contract, performance, assignment, rights of third parties and discharge of contract. The second book deals with the general discussion of principles of agency and a long discussion of the duties and liabilities of all parties connected with the relationship. The next subject is a case and text treatment of negotiable instru-

ments. A very excellent discussion is given of the doctrine of negotiability and the types of instrument that can be negotiated, with careful setting out and designation as to proper language and form required to create the instruments of these types. This discussion of negotiability is one of the best that the reviewer has seen in any of the recent books, and it strikes him that such a work will be invaluable for a man interested in banking and banking institutions. It is interesting to note that the authors' next chapter deals with banks and banking.

The second portion of the book deals with business organizations and, as in the chapters on negotiable instruments and contracts, the authors use the text and case method. In the questions of business organization the book begins with a treatment on partnerships and then is followed by a long section on corporations. The next chapter deals with matters of personal property, sales bailments and security relations, chattel mortgages, conditional sales, suretyship, and a special chapter on the contract of insurance. The seventh chapter has as its content the general subject of real property, paying especial attention to real estate mortgages, landlord and tenant, mechanics' lien laws. The authors have added as their last chapter a discussion of trade regulations and business torts. In adding these last chapters on trade the authors have gone further than most writers on business law have done. To be sure, Professor Isaacs in his recent book deals with Federal practices, but it is the general scheme of most writers on business law to limit the subject matter to problems dealing with contracts and specialized contracts, securities, principles of organization; such subjects as trade regulations are ordinarily left to independent books, such as Dykstra's works on the relations of government and business. There may be some strong arguments for limiting subject matter of business law rather than tending to expand it into this new and extensive field, but it may be an experiment worth trying. One practical difficulty is that the shortness of time allowed the subject, ordinarily only three hours a semester, is not enough to cover all of the subjects suggested. It is not part of a reviewer's job, however, to discuss the book he thinks the author should have written, but to express some opinions on the merits of the book that has been produced.

One of the most interesting things in reviewing the book is to look beyond the pages to the scholarship and capacities of the men who have written it. Both have had long experience in the law, in teaching and in active practice, and one of them is as well advanced in accounting as he is in the field of law and jurisprudence. Hence the outlook that these men would have upon the subject is certain to be thorough, painstaking, and broad. It is the opinion of the reviewer that this book, like its predecessors, will be well received by the teaching profession, and the already well-established position of the authors will be continued. It also strikes the reviewer that the book will find appeal among bankers and brokers and real estate dealers as a sound text on banking, brokerage, and real estate practice.

The authors have been very careful in this edition to exclude or shorten some of the earlier cases, and have very profitably introduced some later ones. Also, in their treatment of the subject, they have in several instances expanded the factural matter of a case, which will surely make the legal discussions much more interesting and instructive. This reviewer is sure that the position of the two writers will not only be sustained but will be decidedly enhanced by this fresh evidence of their scholarship and knowledge of their subject.

E. S. WOLAVER

School of Business Administration
University of Michigan

Money and Banking. Revised Edition. Charles L. Prather. (Chicago: Business Publications, Inc., 1940. Pp. xiii, 903. $4.00.)

Doctor Prather is Professor of Finance at Syracuse University. His first edition has been used and criticized constructively by teachers in various colleges according to his preface. The old edition has been rewritten to some extent and enlarged by 344 pages. We must assume that this text is what some professors in various colleges think that an undergraduate should learn on the subject. It may or may not be wise to have the work reviewed by a bank man, especially by one who did not review favorably the first edition and who now finds the revised edition is only more of the same thing.

The book gives a mass of information, in readable form. It gives a bird's eye view of the field. It contains a good bibliography, a good index, and questions at the end of each chapter which not only cover the text but require some outside reading. The criticism of our silver policy is good.

Criticism falls especially on two matters: the text contains too many errors; and the atmosphere is unfair to American banking.

Except for the surprising number, one would not mention mis-spellings, such as "aceptance" (p. 567), or plural subjects wedded to singular verbs. This must be due to faulty proof-reading. But it irks a bank man to read: Bank of Providence (instead of Providence Bank) (p. 292); travelers checks are issued in $200 pieces (p. 564); the buyer of a bank money order eventually receives from abroad the original order (p. 504); banks stop payment of your check on a bare telephone request (p. 230); discount companies are in the habit of pledging their receivables to secure debt to bank (p. 420); directors of banks (he makes no exceptions) serve without compensation (p. 280); bankers acceptances sell today at $\frac{1}{8}$% brokerage (p. 560) and the broker endorses the acceptance when he sells to a bank (p. 424). My notes cover thirty such inaccuracies not including typographical errors.

It is not so easy to give chapter and verse as to the general teaching of the book. Consider emphasis, for example: 16 pages only are given to the trust department and its usual operation; 55 pages are given to U. S. Government lending agencies, 22 in all, which the author likes. Severe criticism is directed at banks and bankers in United States through the bank holiday, without discussion of why confidence was impaired; but (p. 428) we read "no bank in England has failed since 1870," which is a half-truth only. In a brief, bitter com-

ment on the Morgan loan of 1895 he gives no praise for the result nor explains why the loan was necessary; but read his comment on the London Economic Conference 1933 (p. 104) "Even before the conference had met, the United States had shifted from emphasis on an international to emphasis on a national policy." A parallel case would be to describe the present world war as a temporary unpleasantness. The author gives no criticism or background for the failure of Creditanstalt, Vienna (p. 532) or for the trouble with Germany's banking (p. 844) and as to England's being forced off gold, apparently (p. 831) it was an act of God: "England's departure from the gold standard in 1931 saved that country from much of the deflation to which the United States was subjected in 1932." Discussing U. S. banking in 1933–6 (p. 238) he says "After vainly trying to persuade business men to borrow and bankers to lend, the government" . . . started its policy of deficit and pump priming. One looks in vain for reasons why business did not borrow; the word "confidence" is not conspicuous in the volume, although experience teaches that it is the essence of money and banking. Such passages are too numerous to mention them all in this review. The credo which they seem to support is: American banking has been less successful than banking abroad; the fault lies with American bankers, therefore we need more legal restrictions on bankers and banking and it is quite possible we may have to fall back on government operation; even this would not be too bad, for our government has had favorable experience through its loaning agencies and has shown wisdom in handling money and banks.

Although the author gives many references, frequently for facts of common knowledge, he indulges occasionally in pure assertion; no reference; no supporting argument; merely "ipse dixit." For example, (p. 708) discussing savings bank life insurance: "the general welfare calls for an expansion of this program, and the long run effects should stimulate interest in all types of insurance." This is an opinion, shared by many reformers. There are many opposed, not only insurance men but savings bank men, and they have a weighty case. The author does not mention for example, the subsidy given the scheme at the expense of the taxpayer, and it is really not at once apparent; nor does he state how far such insurance in force is benefitting those who would buy otherwise some "industrial" policy.

This edition repeats that good banking is the product of good laws and good bankers. Few bankers will agree. Good banking is the product of good bankers, just as good teaching is the product of good teachers.

W. G. Meader

Industrial Trust Company
Providence, Rhode Island

Capital Expansion, Employment, and Economic Stability. Harold G. Moulton, George W. Edwards, James D. Magee, and Cleona Lewis. (Washington, D. C. The Brookings Institution, 1940. Pp. xv, 413. $3.50.)

It has come to be generally accepted that the failure of economic conditions in the United States to attain a full measure of prosperity has been due largely to stagnation in the capital markets. No agreement as to the causes of such stagnation has, however, been achieved. The book here reviewed presents an evaluation of numerous causes which have been assigned. The evaluation rests upon a thorough analysis of the changes which have taken place during recent years in the capital and money markets and the conclusions are well supported and should stimulate thinking on numerous aspects of public policy.

The analysis indicates that the restricted flow of funds into investment cannot be explained by abnormal conditions in the private capital market. There is a substantial volume of investment money and more than enough short-term credit resources. There is also sufficient underwriting capital, and the credit position of American corporations is on the whole reasonably satisfactory. Moreover, the available data do not support the current thesis that the disappearance of the frontier and a declining rate of population growth have brought about a stage of economic maturity necessitating extensive supplementation of private by public enterprise. The authors insist that possibilities of great capital expansion still remain. The foundations upon which such possibilities rest are the needs accumulated during the past decade, the increase in population estimated for the next 40 years, and the opportunities incident to the raising of the standard of living for the population as a whole.

Since stagnation in capital markets cannot be explained by abnormal conditions in those markets, the authors find the principal causes to consist of government regulations and other public policies. Contrary to the belief held in some quarters, the conclusion is reached that federal and state regulation of security markets has been a contributing, but not a major, factor in the capital market situation. Greater emphasis is placed upon taxation. The existing taxation system, the authors believe, encourages investment in high grade bonds, particularly tax-exempt issues, and discourages investment in equity securities. Inasmuch as the primary need is for expansion of capital through stock flotations, the effect of present tax laws upon the expansion of private enterprises is serious. The authors suggest in particular three changes in the tax system: (a) the surtax rates in the upper brackets should be substantially reduced; (b) the normal income tax on corporate dividends should be eliminated; and (c) capital gains and losses should be disregarded or, if capital gains are taxed, deductions for capital losses should be allowed.

Present fiscal policies and the development of government credit agencies are believed to have lessened the disposition of both enterprisers and investors to assume risks involved in long-term capital commitments. Especially to be noted are the growth of the public debt and the appearance of a philosophy that a permanently unbalanced budget is essential to the maintenance of prosperity.

Joseph L. Snider

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Harvard University

Municipal and Governmental Accounting. Carl H. Chatters and Irving Tenner. (New York: Prentice-Hall, Inc., 1940. Pp. vi, 794. College list, $4.50.)

This book is a welcomed addition to the limited text material available in the field of governmental accounting. Its twenty-four chapters covering 520 pages of text are divided into six sections as follows:

I. Nature of Government and Essentials of Governmental Accounting.
II. Funds
III. Revenues and Expenditures
IV. Assets and Liabilities
V. Reporting
VI. Federal Accounting

The text is more than a book on the specialized subject of governmental accounting. A background of political science is provided early in the volume, while the application of general accounting and public finance runs throughout the book. The development of governmental accounting is made from the basis of the fifteen principles of municipal accounting as defined by the National Committee on Municipal Accounting. The authors apparently intended that the book serve a dual purpose, i.e., as a manual and reference book for municipal finance officers, and as a college text in governmental accounting. From the viewpoint of the former, the presentation is excellent, each chapter being a complete work on that particular subject. As a college text, the completeness of each chapter provides some duplication when the same subject is treated from different viewpoints in other chapters. This duplication, perhaps, is not objectionable from the teaching standpoint, especially in classes at the undergraduate level.

Following the two chapters covering the political-science background and the explanation of the principles of governmental accounting, the text discusses each type of fund in detail showing its use and purpose. Illustrative statements and model journal entries are presented for each fund. The eight chapters in Section II treat the general and special revenue funds, bond funds, sinking funds, working capital funds, special assessment funds, trust and agency funds, and utility funds, as well as fixed assets and bonded debt.

Sections III (Revenues and Expenditures) and IV (Assets and Liabilities) provide some duplication of material already discussed in the section on funds. Chapters on Budgeting, Cost Accounting and Classification of Accounts are included in Section III along with those on Revenues and Expenditures. Utility revenues and expenditures are treated in another chapter. Each of the major classes of assets and liabilities are discussed in separate chapters in Section IV. Section V, consisting of only chapter twenty-three, provides an excellent description of material that should be included in the annual and monthly reports.

The fifty-page chapter on Federal Government Accounting is an uncritical description of the federal accounting system as it operates. No recommendations are offered and no references made (except in the bibliography) to the many improvements that have recently been suggested. Perhaps this chapter is offered as a subtle contrast to the remainder of the book in which the desirable procedures of governmental accounting are emphasized rather than current practice. A two-page glossary of terminology specifically applicable to the federal system concludes the chapter.

Any criticism of the basic theme of the text would be a criticism of the National Committee on Municipal Accounting. However, it would have been more enlightening to the student had certain alternative procedures been described in several places. For example in accounting for bonds purchased for investment purposes it is suggested that the bonds be entered at par with the premium or discount set up in a separate account to be amortized over the life of the bonds. In view of satisfactory commercial practice, why shouldn't the bonds be entered at cost with the amortization of premium of discount being carried directly to the bond account? In describing budgeting for the general and special revenue funds the procedure of entering the budgetary and proprietary accounts in the same general ledger is prescribed. In discussing budgeting for utility funds the procedure of carrying the budget as a memorandum and that of separate budgetary and proprietary ledgers are presented. Since each of the three methods is being used successfully by municipalities for their general fund, it would seem better had the relative merits of each been presented as possible budgetary procedures for the general fund.

Following the text are three appendices containing twenty-eight pages of governmental accounting terminology, twenty-nine pages of bibliography, and 205 pages of questions and problems.

The terminology section is a composite selection taken from *Municipal Accounting Terminology* by the National Committee on Municipal Accounting, *Manual of Water Works Accounting* by the Municipal Finance Officers' Association and the American Water Works Association, and *Local Government Debt Administration* by Chatters and Hillhouse. The listing of bibliography by chapters provides some duplication in the repeated listing of works by Morey, Buck and other well known authors in the field. The 249 questions and 153 problems provide ample teaching material. It is clearly evident that many of the problems have been taken from the authors' experiences in practical situations with the Municipal Finance Officers' Association. Very few of the problems have been taken from C. P. A. examinations. Most problems are of moderate length. Less than a dozen could be classed as long. No practice set is included.

As a whole the book is well written and presents a comprehensive picture of the accounting techniques applicable to municipal units. Every practicing accountant and municipal finance officer should have this work available for reference.

W. H. Read

University of Tennessee

State Supervision of Local Budgeting. Wylie Kilpatrick. (New York: National Municipal League, 1939. Pp. 131. $1.00.)

As an authority in the field of state supervision over local finance, Dr. Kilpatrick is well qualified to discuss

the subject of state supervision over local budgeting. The importance of this subject is evident from the fact that two-thirds of the states require local preparation of budgets and in one-half of them this preparation must be according to state-drafted forms. Moreover, the supervision exercised in some states is far from satisfactory. In these states, supervision has come to stay and the problem is how to make it effective. But there is also the additional question as to whether supervision is needed. The author's answer is in the affirmative and his aim is to show the form that supervision should take.

A distinction must be made between supervision and control. For "supervisory relationships do not disturb local responsibility within specified fields. State control, on the other hand, reduces the responsibility of the localities to that of mere agents carrying out state orders." The author advocates supervision over local budgeting, not control. He visualizes the state supervisory agency in the role of counsellor and guide rather than as an agency to administer the financial affairs of the local units. Only when the localities get into financial difficulties should the state attempt to exercise control. It is not always easy to tell when a unit has reached this stage but a few states have already specified the conditions when they will begin to exercise control. The author suggests some of the following tests:

1. Default on the principal or interest of bonded debt.
2. Excessive delinquency in the collection of taxes and special assessments.
3. Budgetary deficits if above a given per cent of current revenue for more than two years.
4. If the local unit derives an unduly large proportion of its revenues, say 50%, from the state or from other outside sources.
5. The continued disregard of prescribed budget and fiscal requirements.
6. Exorbitant local expenditure, that is, the unit's expenditures exceed the specified maximum for units of the same size of population and similarly situated as to economic resources.

These are, however, the exceptional cases. Under ordinary circumstances, the state should limit its activity to supervision. It should provide the administrative means for flexibly enforcing the necessary state regulations according to which the local units may adopt budgets of their own choice. For example, statutory rules should prescribe the method of estimating revenues and expenditures taking into account such factors as surpluses or deficits, tax yields, tax delinquencies, offsets for uncollectible revenue, reserve accounts, illegal expenditure, and emergency appropriations. The types of statements to be required and the classification of the financial data to facilitate the budgeting process are also considered but only briefly. The budget would be submitted to the state agency after its adoption but before it went into effect. This agency would check the budget for compliance with the prescribed rules and legal provisions and validate it. Provision should be made for the granting of exceptions under certain circumstances and an appeal body should be set up for this purpose.

This procedure does not, however, complete the budgetary process. For the author advocates review of the budget every three months, so as to take account of changed conditions. Budget changes would, of course, be subject to ratification by the state supervisory agency.

Dr. Kilpatrick would not limit state supervision to the current budget; he would expand it to include the capital budget. Here is an opportunity to put to good use the work of over 1,600 local planning boards now already established in the United States. The state should set up a procedure whereby capital improvements can be properly programmed in relation to the regular budgeting of the governmental units. Here, too, emphasis is laid on the fact that the initiative must be with the local units. "The machinery for the initiation and execution of long-term programming is and must remain local, but the state can assure the local use of this machinery, assist in its operation, and cooperate with the communities for state purposes."

Some important observations are made by the author with respect to the relationships between the state supervisory agency and the local units. In the first place, each unit should designate a finance officer with whom the state supervisory agency can deal. Secondly, local planning and review commissions that are representative of all the local units within a community area should be set up, so that the finances and activities of all the units in the area might be considered. The state must help these commissions not only through its reviewing function but also through furnishing expert advice.

As far as the state organization itself is concerned, the author advocates the establishment of an agency whose functions would be limited to supervision over local finance. It should have the same status as other state departments and should be separate from the state finance agencies such as the state auditor, tax commission, treasurer, or finance department. It would, moreover, not be advisable to have one big department supervise all local government. "Only as the finance supervisory agency is specialized in its work, capable of rendering services nowhere else available, is state supervision justifiable . . ." because "the objective . . . is a specialized staff capable of rendering consulting services and of cooperating with local officials, citizens, and organizations."

In conclusion, it may be said that Dr. Kilpatrick has made a valuable contribution to the field of state supervision over local finance. Many of his proposals have already demonstrated their practicability through use in some states; others await the test of experience. What the reviewer likes particularly about these proposals is that they do not take away initiative from the local units.

IRVING TENNER
Municipal Finance Officers Association

New York Laws Affecting Business Corporations, Annotated. J. B. R. Smith. Twenty-first edition. (New York: U. S. Corporation Company, 1940. Pp. xxxii, 584. $2.00.)

This twenty-first annotated edition of this book is

revised to April 30, 1940. It includes all the laws related to New York Business corporations as amended and changed by the Legislature which adjourned early this spring.

The changes were substantial, consisting of 30 separate enactments amending, repealing, or adding 43 separate sections of the statutes; perhaps 25 of these sections are of major importance. These changes are of more concern to lawyers than of accountants, but some of the changes relating to taxes have a marked accounting significance. Tax law changes outnumber all others.

In addition to the statutes, judicial decisions are referred to liberally and the notes are more than decision digests; they contain the author's explanation of the case, abstracts in the Court's exact language, and numerous citations to supporting decisions.

A glance at the subject arrangement shows how complete is the corporate entity coverage:

I. Corporate authorization
II. Corporate procedure
III. Corporate structure
IV. Corporate personnel
V. Corporate powers, rights, duties and limitations
VI. Corporate termination
VII. Corporate reorganization and extension
VIII. Fees and taxes
IX. Foreign corporations

The list reads like the subject division in a standard text on corporate organization and management.

These annual editions should be valuable to accounting students, teachers, and C.P.A. examinees interested in legal principles governing corporate accounting work of New York corporations. Dozens of corporate problems used in professional examinations, and solved in accounting publications, are of little, if any, value within the jurisdiction of New York courts. Either the problem or its published solution is inaccurate in New York; sometimes both are woefully in error. This reviewer finds it necessary each year to recheck against the latest edition of this book every corporate problem used in the various courses in which such problems find a place.

George E. Bennett

Syracuse University

Public Finance. Second Edition. Alfred G. Buehler. (New York: McGraw-Hill Book Company, Inc., 1940. Pp. xx, 846. $4.00.)

This second edition of Professor Buehler's ***Public Finance*** follows the same basic outline as his first, but there are certain helpful changes. There is more ample discussion of many of the basic problems which are found in any orthodox volume on public finance, and the influence of the changing times on the financing of domestic and foreign governments is apparent. The lingering effects of a depression, the general war conditions, and the unprecedented spending in the United States are bound to have their effect on any properly prepared book of this sort. The author has not followed the line of least resistance by any means. It might have been simpler to have followed a discussion of basic principles, letting a practical world take care of itself, but the entire book gives the reader the feeling of the present-day world, not just the discussion of "closet" theories.

We are sometimes amazed by the increased spending of our federal government, but we must not forget that the state and local governments are also the custodians of vast sums of public money. The author does not lose sight of this. The proportion of space devoted to each phase of public finance is nicely balanced, while the two are properly interwoven. It must be recognized that if we do not have adequate knowledge of our local financial problems we cannot expect to criticize wisely our federal financing.

The author has written a book profound and scholarly enough for the student in the classroom, but in such a manner that it may be read with benefit and understanding by anyone interested in the subject. This reviewer has often contended that everyone should know more about public finance. Anyone who assumes a "laissez-faire" attitude on such a subject is acting in an illogical manner. The only way any lasting improvement can be expected in the big business of government, in which each of us has an interest, is through understanding how it is managed and how it is financed. It is through the reading, and the study which follows the reading of such books as this, that we may control our government intelligently. Criticism without knowledge s futile and will often result in making conditions worse instead of better.

The emphasis in the text is on taxation, and the usual subjects of kinds of taxes, shifting and incidence of taxes, and distribution of taxes are discussed. It is refreshing to pick up a text on public finance, however, and find that the subjects of accounting, budgeting, and reporting are recognized. Not only are these subjects recognized, but they are given a proper place in the system of public finance. It is unfortunate that many of us assume we are on one side of the fence or the other, taxing or spending. We must recognize that neither can exist properly without the other. One cannot profess to be well-rounded in the field of public finance unless he is familiar with governmental accounting, nor can the governmental accounting student go far unless he knows much about public finance. This is true of the general accountant, regardless of how expert he may be. There are many procedures in the field of governmental accounting which are different enough in their proper application to make the efforts of the general accountant harmful, if he does not have the special knowledge involved in both governmental accounting and public finance. Of course the author treats the subjects of budgeting, accounting, and reporting from a non-technical point of view. It could not be otherwise; technical governmental accounting is a subject within itself, which presumes certain basic accounting knowledge, and which must be treated accordingly. The recognition of this field of governmental accounting is encouraging, however, since it must be recognized that regardless of how elaborate a financial system might be set up, it could be of little avail or efficiency without adequate budgeting, accounting, and reporting.

Other new chapters which have been added to this edition deal with regulatory taxation and federal and state grants. These certainly express the trend of the times and help to make the reader aware that he is dealing with a text and an author aware of present trends.

The author says that "public finance embraces the divisions of expenditures, the raising of revenue by taxation, borrowing, and other methods, and the financial administration of governments." He has treated all of these phases. Each chapter is followed by a list of recommended references for supplementary reading which are adequate for the reader who wishes to go more deeply into the subject under discussion, and include many well-known authorities on each subject.

It has been emphasized that the author has brought a modern touch into the book. He has not left out the historical phase of the various subjects. The study of the history of public finance can be considered a field in itself, and could not be studied completely in a work of this sort, but the author achieves comprehensiveness by treating the history of various phases adequately at appropriate places.

After the usual introduction the author devotes a chapter to fiscal organization of government, four chapters to expenditures, one to federal and state grants, one to economic and social aspects of public spending, and one to controlling governmental costs. Three chapters are given over to budgeting, accounting, and reporting, after which two chapters discuss national, state, and local enterprises. This is followed by chapters on the tax system, shifting and incidence, and distribution. A series of chapters then deals with general property tax, estate and inheritance taxes, taxes on selected commodities, general commodity taxes, customs duties, income taxes, other taxes and revenues, bank and insurance company taxes, public utility taxes and regulatory taxes, followed by problems of the tax system. The volume closes with a series of five chapters on borrowing. There are thirty-four chapters in all.

This volume is readable, comprehensive, and modern. It treats the subject matter in a scholarly manner, and should be as teachable as the first edition has been, with more value to the student and the reader.

ROBERT P. HACKETT

University of Illinois

Illinois Tax Problems. Symposium. (Illinois Tax Commission, 1940. Pp. xii, 423.)

This book contains the proceedings of an open forum on taxation and tax problems in Illinois, sponsored by the Illinois Tax Cemmission in December of 1939. Forty citizen groups and agencies were represented at sessions in which sixty scheduled speakers discussed the tax problems of Illinois from the points of view of the taxpayer, the tax administrator, and the public official.

In the introduction to this volume, Simeon E. Leland expressed very well the tax situation in Illinois; he said: "The tax problems facing Illinois today are legion; they are no more confined to any one phase of the complex tax structure than they are to any section of the State or any one strata of its economic or social life. Yet the very character of these problems constrains the public officer and the taxpayer alike to give considered attention to each factor."

There are fifteen thousand governmental units in Illinois, about four thousand greater than that of any other state, and the following major sources furnish the $550,000,000 to $600,000,000 per year necessary to operate these units: general property tax (over 50%), sales tax (over 15%), and motor fuel and licenses taxes (10–12%). The balance is composed of liquor and business taxes, license fees, inheritance taxes, special assessments, and miscellaneous revenues.

Parts I and II of this book contain a discussion of citizens' organizations for tax relief and research, and of the taxpayers' attitude toward government and taxation. Too frequently, citizens' organizations have expended their energies in trying to shift their tax burdens to other groups instead of working for the elimination of waste and for the installation of budgetary and accounting systems by governmental units. Many citizens' organizations, however, have done fine work in improving the financial condition of some government subdivisions.

Only urgent and major problems of the Illinois tax situation were taken up in the Forum. Part III is devoted to problems and financing of urban government. The major expenditure problems—education, relief, and highways—are discussed in Part IV.

Part V is concerned with the property tax and its improvement. Although the State does not use the property tax for its own support, that tax is the most important source of revenue, because most of the local government units depend on it for a major part of their revenue. Tangible property has been grossly overtaxed, while intangibles have escaped much of their just burden. However, the taxation of intangibles has been improved by the use of duplicate copies of Federal income tax returns.

The next two parts of the book contain selections regarding tax collection and tax delinquency problems. In addition to economic conditions, the chief causes for tax delinquency are poor assessments and the inability of a new owner to acquire clear title to property following tax sales. The outlook is favorable, however, because there has been a recent decrease in delinquencies.

Tax reform and improvement are handled in Parts VIII and X; the former contains a discussion of the taxation of public utilities, oil rights, and business. The injustices of inheritance taxation are discussed in Part IX.

There is substantial agreement among the various contributors on many of the points discussed. Most of the tax difficulties in Illinois are traced to outmoded tax bases and methods, poor collection methods, inadequate assessment and review machinery, governmental waste, superfluity of local government units, and an outmoded and inadequate state constitution. Centralization and improvement in the machinery for tax administration, improved statutes, and promotion of government efficiency through the use of better budgetary and general and cost accounting systems are the remedies suggested.

The first seven parts of the book are factual in nature and are chiefly of value in that they portray the present poor tax situation in Illinois. The remaining parts are more interesting, because they are more theoretical than are the first portions.

"In order that the educational work that has been started here may be continued, the Illinois Tax Commission will publish and disseminate a volume of these proceedings, available without cost."

CHARLES J. GAA

University of Illinois

Time and Labor Saving Ideas in Accounting Procedures. From Business Ideas for Increasing Profits, Prentice-Hall, Inc., edited by P. S. Seidman. (New York: Prentice-Hall, Inc., 1940, pp. 12, complete service $18.00 annually.)

This material constitutes one of twelve sections of the Prentice-Hall Business Ideas Service, the purpose of which is to bring to one's attention ideas that have demonstrated their value in actual practice. Ideas and data were collected by Mr. Seidman by correspondence with accountants throughout the country and sundry proven accounting short-cuts and aids presented in these twelve pages (punched, loose-leafed, $8\frac{1}{2}\times 11$ size).

Forty-one ideas are incorporated, classified according to the nature of the work or records involved. This classification includes cash records (7 ideas), sales and accounts receivable (9), purchases and accounts payable (3), general journal (2), ledgers (3), trial balance (5), speeding up preparation of financial reports (4), and miscellaneous short cuts in accounting procedure (8).

Only the method or procedure is described. No attempt is made to elaborate upon advantages or disadvantages for the reason that what might help one concern might not increase efficiency in another.

HALE L. NEWCOMER

University of Illinois

Government and Economic Life. Volume I. Leverett S. Lyon, Myron W. Watkins, and Victor Abramson. (Washington, D. C., Brookings Institution, 1940. Pp. xi, 519. $3.00.)

Government and Economic Life. Volume II. Leverett S. Lyon, Victor Abramson and Associates. (Washington, D. C., Brookings Institution, 1940. Pp. xi, 780. $3.50.)

In these two volumes of 1300 pages the Brookings Institution presents an exhaustive treatment of the relationships of government to economic life in the United States. The work is not only historical and analytical in its approach; it also includes judicious appraisals of past developments and current trends. The volumes are a significant collection of factual material and a stimulating treatment of public policies.

Volume I treats of government and economic life *generally.* It is divided into two main parts, the implementation of private enterprise and the regulation of private enterprise. The treatment of implementation consists of chapters devoted to organizational forms for business enterprise, bankruptcy and reorganization procedures, patent rights, a monetary mechanism, mechanisms to adjust labor disputes, and the provision of knowledge of various sorts to business. The regulation of private enterprise by government has involved principally measures to maintain competition in business and to set the plane of competition. A lengthy chapter is devoted to each of these aspects of regulation. Other chapters are devoted to problems involved in concerted action among workers.

Whereas Volume I is devoted to government and economic life in general, Volume II is devoted to particular relationships of government and economic life and also to governmentally organized production. Seven chapters are devoted to the relationships of the government to foreign commerce, public utilities, transportation, agriculture, the bituminous coal industry, the petroleum and natural gas industries, and the food and drug industries. Two other chapters consider the National Recovery Administration and the effect of war upon the relationships between government and business.

In the portion of the volume devoted to governmentally organized production, attention is given to government as a producer of final goods and services, to public relief, and to social security.

The topical references given above may serve to indicate the wide scope of the work under review, but only by a perusal of the volumes themselves can one appreciate the richness of the historical treatments and the stimulating character of the appraisals.

Of particular interest is the discussion of recent modifications in public economic policy, such as a new emphasis upon individual economic security, greatly increased government controls over private management decisions, and encouragement by the government of the organization of special interest groups. Such modifications of public policy have greatly influenced the thinking of numerous individuals and have raised many questions for public decision. The authors observe, for example, that in the assignment of new economic tasks to government there is reflected a diminished confidence in private enterprise and also a diminished valuation of economic freedom as an end in itself. Moreover, the numerous extensions of governmental activity have placed increased emphasis upon questions of effective administration as contrasted with consideration of the wisdom of the public policy involved. It may prove to be the case that the increased governmental controls over private enterprise may seriously limit the effectiveness of individual initiative without corresponding social gains. Numerous other questions have been raised: Will the policy of undertaking to provide individuals with a source of livelihood over long periods diminish and delay their absorption into private enterprise? May such policies provide unmerited gains for certain groups in society and create a widespread illusion that it is possible to support a large part of our population without serious effort on their part?

JOSEPH L. SNIDER

Graduate School of Business Administration
Harvard University

UNIVERSITY NOTES

University of Illinois

Messrs. Scovill and Moyer have completed a volume entitled "Fundamentals of Accounting," which is to be published in September.

J. R. Taylor has accepted a position at the University of Tennessee. C. J. Gaa received the Ph.D. degree in Accountancy last June, R. K. Mautz passed the Illinois C.P.A. examination in November, 1939.

Indiana University

The following men are leaving the staff: R. D. Swick, who will enter the employ of Caar Canning Company, Redky, Indiana; R. E. Strohlem, who will teach at Purdue University; and D. Thompson, who will become acting head of the department of economics and accounting at Howard University, Birmingham, Ala.

University of Kansas

Professor John G. Blocker has taken a year's leave of absence in order to teach at the University of California, Berkeley, as visiting professor of accounting. Arriving as instructor in accounting is K. Louhi from the University of Chicago.

Marquette University

This year's chairman of Milwaukee chapter of the Wisconsin Society of C.P.A.'s is Professor Leo A. Schmidt. The Auditor of Milwaukee County, Mr. Frank Bittner, will teach a course in Governmental Accounting next semester.

University of Missouri

R. D. M. Bauer, associate professor of accounting, is absent on leave for one year. In Mr. Bauer's absence, G. P. Maynard will serve as instructor in accounting.

Northwestern University

C. M. Gillespie will be absent on leave during the first semester of 1940–1941. E. C. Davies has resigned as assistant dean of the School of Commerce; he will devote full time to teaching. S. Y. McMullen was advanced from instructor to assistant professor of accounting. Professor Specthrie's volume on "Mathematics for the Accountant" will be published in September by Ronald Press Company; the volume, consisting of fifteen instalment chapters, is part of the university's series in accounting.

University of South Dakota

Professor H. E. Olson received his C.P.A. certificate recently.

Agricultural and Mechanical College of Texas

T. W. Leland was re-elected secretary-treasurer of the Texas Society of C.P.A.'s. He will continue as editor of *The Texas Accountant*. Messrs. S. M. Stubbs, and N. D. Durst passed the C.P.A. examination of last May.

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